Federal Administration of Provincial Taxes

New Directions

January 2000

Department of Finance Canada
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FOREWORD

The framework for federal-provincial-territorial co-operation in the area of tax policy has evolved constantly since 1941, the beginning of the "tax rental" agreements between the two orders of government. The objective of this document is to articulate significant changes that are again steering us in new directions and establishing a new era for co-operative administration of federal and provincial/territorial taxes.

The "new directions" outlined in this document are the product of much work on the part of both federal and provincial/territorial officials over the past two years. The core papers that provide the foundation for the new directions are the paper *Tax on Income* (1998) and the new guidelines for the *Federal Administration of Provincial Taxes* (1997). As new issues arise in both of these areas, federal and provincial officials will continue to work, as in the past, to resolve them in a mutually-satisfactory fashion.

The reasons that brought federal and provincial/territorial governments together as partners in tax collection agreements for close to sixty years continue to exist today: these agreements allow the two orders of government to co-ordinate their tax policies, while providing substantial tax policy flexibility to provinces and territories, to simultaneously achieve national and regional social and economic objectives, all in the interest of taxpayers. In a federal system such as Canada's, such agreements provide the balance that is essential for the federal government to focus on national social and economic performance and for the provinces and territories to concentrate on regional social and economic issues, which is rightly their domain.

The face of federal-provincial-territorial relations and, in particular, tax co-ordination is ever changing. The Federal-Provincial Tax Collection Agreements, that replaced the tax rental agreements, were signed in 1962. Since that time, the Agreements have continued to evolve within the same basic framework, and have provided both orders of government with an effective mechanism for the administration of income taxes.

As a 1991 discussion paper on tax co-ordination[1] stated:

> "... the Tax Collection Agreements serve the national interest. They help to reduce complexity and duplication; promote tax harmony and thus the free flow of labour and capital across Canada and economic prosperity; help Canadians identify which order of government is responsible for their taxes; and, at the same time, provide provinces with a degree of flexibility over their tax systems."

In recent years, some provinces and territories have increasingly sought enhanced tax policy flexibility as a means of meeting their own evolving social and economic priorities. Since tax policy and tax administration are inherently linked, this implies that this flexibility applies to both. In recognizing this, the federal government has worked with provinces and territories to identify ways of improving and enhancing the evolution of our tax policy and tax administration arrangements with the provinces and territories in taxation matters. Both orders of government

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[1] *Personal Income Tax Coordination: The Federal-Provincial Tax Collection Agreements*, June 1991, page i.

recognize that, in order to move forward together, the framework for change should ensure a balance between the federal objective of a co-ordinated tax system nationally, and the provincial/territorial objective of policy flexibility.

Four recent developments have contributed to the evolution of the tax policy framework. The first major development under this new balanced approach to provide more flexibility to provinces and territories is federal and provincial/territorial agreement on tax on income. Provinces and territories that are interested in moving to a tax-on-income system are free to do so.

A second development under this approach is the new "guidelines." The federal government administers various tax measures for provinces and territories and collects provincial/territorial revenue, subject to tax collection guidelines developed in 1981. Over time, both the federal government and provinces/territories have expressed dissatisfaction with these guidelines, in principle as well as in application. The federal government has developed new guidelines in close consultation with provincial and territorial governments to address both the provincial/territorial desire for enhanced policy flexibility and the federal objective of maintaining a core degree of harmonization through costing incentives. These new guidelines came into force in January 1998, with appropriate transition for existing measures in existence prior to that date. The guidelines establish the criteria that will be applied by the Department of Finance in determining whether or not provincial tax measures will be administered under the Tax Collection Agreements, and under what costing framework. Revenue Canada will be responsible for the details pertaining to administration.

Another important development is the transformation of Revenue Canada into the Canada Customs and Revenue Agency (CCRA). One of the reasons for the establishment of the CCRA is to create a vehicle that will be able to work closely with provinces and territories in the delivery of programs. By using the services available from the CCRA there is the potential to reduce overall administration costs by eliminating inefficient overlap and duplication between federal and provincial/territorial tax administrations and compliance costs for taxpayers.

A final important aspect that has improved federal-provincial-territorial tax co-ordination, so governments do not work at cross-purposes, is the work of the Federal-Provincial Committee on Taxation. This Committee does, and will continue to, discuss all important federal and provincial/territorial tax policy and administrative changes to ensure that their national and regional consequences are well understood before policy changes are implemented.

The combination of the tax-on-income option for provincial and territorial personal income tax and the new guidelines for federal administration of provincial and territorial taxes represents significant changes to the Federal-Provincial Tax Collection Agreements. Along with the new CCRA and the continuing work of the Committee on Taxation, we are quite convinced that these changes will substantially improve Canadian tax policy and tax administration.

Honourable Martin Cauchon, P.C., M.P.
Minister of National Revenue

Honourable Paul Martin, P.C., M.P.
Minister of Finance

A Provincial Tax-on-Income System for Personal Income Tax: Highlights

This note sets out the highlights of the joint federal/provincial/territorial tax-on-income (TONI) paper that, after extensive discussions, was completed by the Committee on Taxation in October 1998. All Assistant Deputy Ministers of taxation of the eleven provinces/territories with whom the federal government has a Tax Collection Agreement confirmed their acceptance of the document, which was then transmitted to Deputy Ministers of Finance for review and approval. The Deputy Ministers subsequently affirmed their agreement on behalf of their governments. This paper is Annex 2 of this document.

The joint federal/provincial/territorial paper accommodates the provinces' desire for increased tax policy flexibility. For those provinces or territories that choose to move from tax-on-tax to tax-on-income, technical issues particular to their situations may arise. These issues will be resolved jointly, as plans for the implementation of tax-on-income move forward. The resolution of these technical issues will be based upon the principles set in the tax-on-income report included in this document as Annex 2.

Key Points

1. Provinces now have the option of levying their personal income taxes either on taxable income or on basic federal tax.

2. Provinces are required to use the federal definition of taxable income, thus ensuring a common tax base.

3. Provinces/territories will have increased flexibility in establishing their tax structure, with control over:

    - the number of tax brackets (including a zero rate on a first income bracket, if desired)
    - tax rates to go with these brackets
    - any number of surtaxes
    - low-income tax reductions
    - a distinct block of provincial/territorial non-refundable tax credits (to be multiplied by the lowest non-zero provincial tax rate)
    - any number of refundable tax credits.

4. With respect to the distinct block of provincial/territorial non-refundable tax credits:

   (a) Provinces may supplement federal credits or add any additional unique provincial credits.

   (b) Provinces would have the flexibility to not follow any federal increases in a credit in the future as they would be able to maintain the value of a gross provincial credit equal to the minimum of the 1997 value and the current year value of the corresponding federal credit.

   (c) For expenditure-based credits (e.g. CPP, EI, tuition fees, medical expenses, charitable donations), provinces would have the flexibility to increase credits beyond the level of the gross federal credit, although they would not have the option of falling below the federal level.

   (d) Provinces would have the flexibility of crediting charitable donations below a threshold at their lowest non-zero provincial tax rate and the balance at their highest provincial tax rate, while maintaining the two-tier credit structure for charitable gifts.

   (e) To ensure simplicity and consistency, provincial credits would use the same definitions as federal credits, where federal definitions exist.

Federal Administration of Provincial Taxes: Highlights

The new guidelines for the administration of provincial taxes were discussed at the December 1997 meeting of Finance Ministers. These guidelines allow federal administration of provincial taxes with minimal constraints on what these taxes could be (see Annex 3).[1] Provinces would not "poach" – provide incentives available only to taxpayers outside the province to encourage them to relocate to within their province.[2]

Key Points

1. The federal government would administer provincial tax measures that are both harmonized in a policy sense and unharmonized.

2. Harmonized tax measures, within the Tax Collection Agreements and the Comprehensive Integrated Tax Co-ordination Agreements, would be administered either:

   - free of charge if they mimic their national counterparts; or

   - at the incremental cost of administration, if they are harmonized but somewhat different from their national counterparts.[3]

   The costing structure, therefore, offers provinces incentives for harmonization through a virtual elimination of the cost of tax collection for them.

3. For measures that are not harmonized, provinces would be charged the average cost of administration.

4. Following discussions at the Federal-Provincial Committee on Taxation, and for consistency between the personal and corporate income tax systems, it was decided that, to provide further provincial flexibility, provinces may alter, for the purpose of calculating provincial income tax, the value of various federal expense-related deductions through the use of province-specific tax credits.

   - Given that provinces are to follow the federal definition of taxable income, it follows that provinces will apply the same tax rates on the various sources of income.

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[1] These criteria include: legality, an agreed set of basic principles (self-assessment, no double taxation), and mutually acceptable contractual arrangements between Revenue Canada (Canada Customs and Revenue Agency) and the province (fairness, feasibility). See Annex 3, *Federal Administration of Provincial Taxes*, December 1997.

[2] See Annex 3, *Federal Administration of Provincial Taxes*, December 1997.

[3] Provinces will be charged when their measures differ from federal measures. These differences may arise either because the federal or the provincial governments have made changes.

5. As for transition to the new system, all new provincial measures introduced after January 1, 1998 are being administered under the new guidelines. Measures in existence prior to that date will continue to be costed as per the existing agreements, until January 1, 2001, when they would fall under the new guidelines. It would be necessary to renegotiate some existing agreements during this period.

ANNEXES

Annex 1

1999 Tax Policy Conference
Canadian Tax Foundation
Ottawa, Ontario
April 9, 1999

A Federal Perspective on the Role and Operation of the Tax Collection Agreements

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INTRODUCTION[1]

In a federation, responsibilities are shared between central and regional authorities. The precise nature of this division of responsibilities can, and does, take many forms since it is shaped by history and by the unique political, geographic, economic, and social conditions in each country. However accomplished, this division represents an effort to balance the objectives of the central government, which must look at national consequences for policies, and those of regional governments, which can better adapt to local variations in economic and social circumstances and in individual preferences.

The tax system plays a central role in this division of responsibilities and in the ability to meet them. While its primary function is to raise revenues, the tax system has become an increasingly important instrument in achieving social and economic objectives.

Since taxes are the primary source of revenue in most industrialized countries, federations must decide how to share and co-ordinate access to the various tax fields. How this is done in practice varies considerably from one federation to another. In Canada, the British North America Act, 1867, established the basis for joint occupancy of the major tax fields by giving provinces the power to levy direct taxes within their boundaries and permitting the federal government access to any field of taxation.

The sharing of the major tax fields provides provincial governments with the flexibility that has become a central feature of the Canadian federation. However, it also means that the tax policies of various governments interact and hence may conflict. For example, if one province taxed on the basis of residence while another taxed on the basis of the source of income, an individual living in the first province but earning income in the second would be taxed twice. By contrast, someone living in the second province but earning income in the first would avoid tax completely. Co-ordination is required to avoid these consequences.

This paper begins with a brief history of tax co-ordination in Canada, which has been marked by increasing flexibility for provincial income tax policy. Next, there is a discussion of the evolution of the tax collection agreements (TCAs), followed by an overview of concerns with the existing TCAs and a description of recent changes to address those concerns. The paper ends with some brief concluding remarks.

THE HISTORY OF TAX CO-ORDINATION IN CANADA

In 1917, the federal government entered the income tax field in order to finance the costs of World War I. This marked the beginning of the joint occupancy of the personal income tax field, which until then had been used exclusively by provinces and municipalities. British Columbia, in 1876, was the first province to impose an income tax, although some municipalities began levying income taxes as early as 1831.

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[1] The first three sections of the paper reproduce verbatim, or with minor changes, extensive extracts from Canada, Department of Finance, *Personal Income Tax Coordination: The Federal-Provincial Tax Collection Agreements* (Ottawa: the department, June 1991).

It was not until the Depression, when federal, provincial, and municipal governments were all attempting to raise income tax revenues to meet increasing demands, that joint occupancy became an issue. At that time, for the most part, there was little or no co-ordination between governments on the design or administration of their respective tax systems. The lack of a common tax structure and the non-uniformity of tax bases and rates produced large variations in tax burdens between provinces. In addition, tax administration was extremely complex, with a multiplicity of forms, rates, and methods of calculation.

In evaluating this situation (which is frequently referred to in the literature as the "tax jungle") the Royal Commission on Dominion-Provincial Relations (1940) recommended that provinces withdraw from the income tax field in order to avoid

> increasing friction between governmental units, increasing double taxation, increasing arbitrary, discriminatory, and confiscatory tax levies, increasing costs of tax compliance, increasing disparities in taxation burdens and government services between regions, and increasing disparities between burdens on and opportunities open to individuals[2].

Although the provinces initially rejected this recommendation, Canada's involvement in World War II necessitated changes to give the federal government access to sufficient funds to finance the war effort. In 1941, the provinces agreed to vacate the income tax and estate tax fields in return for "rental" payments. The tax rental agreements continued until 1962, although with significant changes: Ontario and Quebec withdrew in 1947 but did not (at the time) impose personal income taxes. In 1952, Ontario re-entered the agreement; Quebec implemented its own personal income tax in 1954.

Although the tax rental agreements provided the benefit of uniformity of personal income tax across the country, they were subject to criticism. In particular, they acted as a fiscal straitjacket for provinces that were facing increasing expenditure demands. The provinces could neither set tax rates nor use the personal income tax as a policy instrument. Even though personal income tax revenues were shared with the provinces, the fact that the federal government set tax policy and collected taxes meant that there was a strong tendency for taxpayers to see the federal government as the sole taxing authority.

To move beyond the limitations of the tax rental agreements and thus to allow provinces flexibility in the design of income tax policies, in 1962 the federal and provincial governments agreed to a new form of co-ordination — the tax collection agreements. TCAs were signed by the federal government and all provinces except Quebec (which chose to retain its own personal income tax system). In addition, all provinces, including Quebec, adopted a common formula for allocating income among them for tax purposes — namely, taxation of individuals on the basis of residence (the province of residence as of December 31 of the year).

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[2] Canada, *The Report of the Royal Commission on Dominion-Provincial Relations*, Book II, (Ottawa: King's Printer, 1940), 134.

The history of personal income tax co-ordination is marked by change, both in the degree and form of co-ordination and in the number of provinces that have entered into formal tax co-ordination arrangements with the federal government.

Under the TCAs, the federal government has also agreed to administer and collect provincial corporate income tax. All provinces except Ontario and Quebec entered into the original agreements. In 1981, Alberta withdrew from the corporate income tax agreements but remained part of the personal income tax agreements.

Similar types of agreements have also been established recently in the sales tax field. In 1997, the provinces of New Brunswick, Nova Scotia, and Newfoundland signed comprehensive integrated tax co-ordination agreements (CITCAs) with the federal government to harmonize their provincial sales taxes with the goods and services tax (GST), creating the harmonized sales tax (HST). Quebec's provincial sales tax is quite similar to the federal GST.

THE TCAs

This section sets out the conceptual framework of a TCA and then describes the historical evolution of TCAs in Canadian federal-provincial relations.

The Framework

A TCA is a combination of

- *a policy framework* that provides a balance (however defined) between provincial tax policy flexibility and the need for federal-provincial harmonization; and

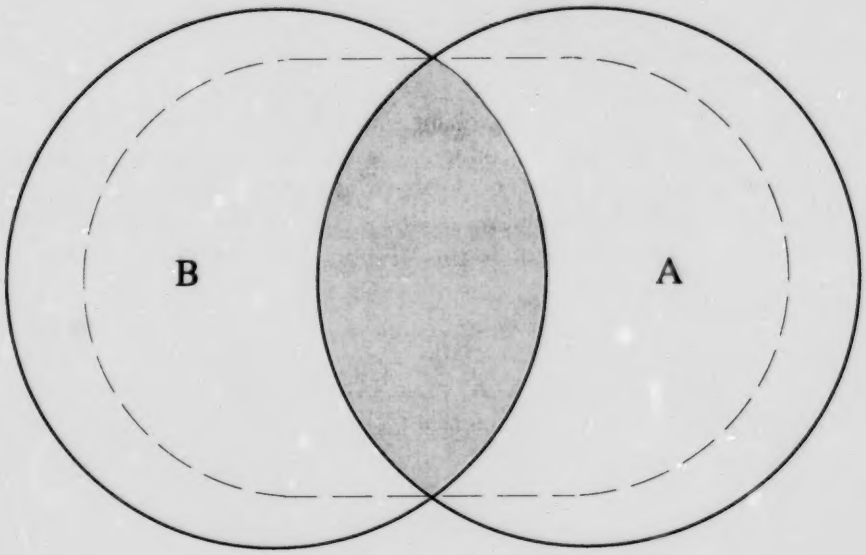
- *a single administrative process* for the collection of taxes.

By necessity, a TCA provides a compromise between the competing objectives of central and regional governments. The central government strives toward the achievement of national social and economic objectives, whereas a regional government (rightly so) focuses on regional social and economic objectives. While there may be a degree of conflict between these national and regional objectives, there could as well be some complementarity. The central government cannot ignore the fact that regional governments are closer to their populations and may at times have a more direct impact on the achievement of certain social and economic objectives than the central government. Regional governments are likely to recognize that ignoring national consequences of regional policies could weaken the national economy, with negative consequences for *all* regional economies. This overlapping of national and regional interests was the main raison d'être for the tax rental agreements and for the current TCAs.

Figure 1 illustrates this framework. It explains the nature of the differing federal and regional objectives and shows how TCAs can improve both national and regional welfare.

Figure 1

Federal and Regional Objectives and the Optimality of Tax Collection Agreements



Solid circle A in the figure reflects federal objectives for the overall national economy that can be achieved with one set of policies, either policies that are totally centralized or federal-regional policies that are perfectly harmonized. Solid circle B correspondingly represents regional objectives and regional policies that can be achieved by regional policy control. The overlapping area indicates that, to some extent, federal and regional objectives and interests overlap.

In this context, what is the role of a TCA? In the absence of such an agreement, the two levels of government could be working at cross-purposes, with the policies of one negating those of the other. At the extreme, one could achieve the A objectives or the B objectives, or some portions of the two. A TCA can stop this negation to some extent and provide rules for the achievement of federal and regional objectives.

What could be the parameters of such an agreement? A TCA will obviously impose some constraints on the federal pursuit of harmonized policies, pushing the right wall of circle A inside to the left. The extent of this movement would indicate part of the federal objective that would be difficult to achieve. Any provincial constraint will simultaneously push the left wall of circle B inside to the right. Assume that such an agreement provides the new dashed walls for circles A and B as shown in figure 1. The new dashed shape, under an agreement, reflects the extent to which federal and regional objectives can be achieved, with some constraints on both federal and regional policy flexibility, but expanding the zone of achievement of the combined objectives.

The next question that arises is, what is the rationale for changes to the TCAs over time? The answer naturally depends upon the movement of both federal and regional objectives and the availability and use of policy instruments in figure 1. A small, further leftward movement of the dashed line of circle A could allow a substantive leftward movement of the dashed line of circle B. This would suggest that a marginal reduction in policy harmonization under the agreement, with increased provincial policy flexibility, may increase overall national and regional welfare. The reverse may also be true where reduced provincial flexibility in other circumstances could be good for the national and regional economies. Under all such changes, it would be optimal to renegotiate the TCA.

Another aspect of welfare maximization to consider, in dealing with the development of or change in an agreement, is that any increased regional flexibility and reduced harmonization may, in certain circumstances, be complemented by the use of other tax or non-tax instruments, to allow both levels of government to achieve their respective objectives that have become constrained by a new, or changed, agreement.

The second aspect of a TCA is that there must be a single administrative process for the collection of taxes. To the extent that a policy framework has been agreed to, there should be no conflict in federal-regional objectives. A single administration avoids overlap and duplication, improves compliance, and should reduce collection costs through the economies of scale. The collection of provincial taxes by the federal government under the TCAs and CITCAs is an example of this lack of administrative conflict.

The 1962 TCAs

The 1962 TCAs were designed to allow provinces to impose personal income taxes directly, while maintaining a degree of tax uniformity among provinces and between the federal and provincial governments. The basic terms and conditions of the 1962 agreements were straightforward. In signing the TCAs, the federal government agreed to

- collect and administer provincial personal income taxes,
- pay provinces the value of the income tax assessed, and
- provide this service without charge.

For their part, the signatory provinces agreed to

- impose a single rate of tax, calculated as a percentage of the basic federal tax;
- make their income tax acts parallel to the federal Act; and
- provide the minister and the Department of National Revenue with all the powers necessary to administer and collect provincial personal income taxes.

The TCAs gave the provinces the ability to determine their revenues independently by enabling them to apply their provincial tax as a single percentage of the basic federal tax – the tax-on-tax framework.

Although the tax-on-tax framework gave each province flexibility over its tax rate and, hence, over the aggregate tax burden and revenue yield of its personal income taxes, the federal government determined the income sources subject to tax, the allowable deductions and exemptions, and the marginal tax rates and income brackets used to compute the tax. Each province then applied a provincial tax rate to that amount to calculate the provincial tax liability.

Taxfilers thus faced a single tax system with a relatively simple administrative process; participating provinces had direct access to the personal income tax field without having to establish their own tax administrations. Since the calculation of provincial tax liability required simply the application of a single percentage to the basic federal tax, taxfilers could determine their provincial liabilities by making only one additional computation. A single annual return could be completed by each taxfiler and sent to the federal authorities.

The Evolution of the TCAs

Over the three decades since the TCAs were first put in place, major changes have occurred, both in the role of the provinces in the economy and in the use that governments make of the personal income tax system. Throughout the 1960s and 1970s, all levels of government began to play an increasing role in the economy, not only in fiscal and economic policy matters, but also with regard to social policy. The federal government, for instance, introduced such measures as high-income surtaxes, the child tax credit, and the sales tax credit.

These new developments naturally disturbed the balance established between the need for policy harmonization and the need for flexibility in provincial policy. To deal with such new developments, the TCAs were amended on various occasions to give provinces increased tax policy flexibility, allowing them, for example, to introduce low-income tax reductions, high-income surtaxes, income-tested credits, and economic-incentive tax credits.

As the TCAs were amended to incorporate these special measures, concern arose about the impact on harmonization and simplicity. To re-establish the balance between federal and provincial needs, the federal government announced in 1981 that, under the TCAs, it would provide increased provincial policy flexibility and would, for a fee, administer special measures on behalf of the provinces so long as they satisfied certain conditions – referred to as the MacEachen guidelines – critical to national objectives.

- *Effective administration.* The tax measure must be capable of being administered in an effective manner in order to preserve the efficiency and credibility of the system, including being within the legal jurisdiction of provinces.

- *A common tax base.* The tax measure must respect the common tax base by not changing the federally defined personal and corporate income tax bases.

- *Free movement of capital, labour, goods, and services.* The tax measure must not impede the free flow of capital, goods, services, or labour within Canada.

The TCAs Today

Given their evolution since 1962, the TCAs today give the provinces considerable policy flexibility and at the same time impose on them certain constraints.

Provincial policy flexibility

Provinces are able to use the personal income tax system as an instrument for achieving certain social and economic goals. Provinces can:

- use low-income tax reductions to reduce or eliminate income taxes for low-income taxpayers;

- use income-tested credits to provide relief to low- and modest-income individuals from, for instance, sales and property taxes;

- use high-income surtaxes to alter the income distribution results of their tax systems and make them more progressive; and

- use economic development credits, such as venture capital tax credits, as a means of encouraging particular forms of economic activity.

Constraints on provinces

Signatory provinces agree to abide by

- a common definition of taxable income,

- a common method of determining provincial residency and allocating taxable income among provinces,

- a common set of federal tax brackets and rates levied on individuals, and

- a common definition of what constitutes deductions or credits for such things as support for families, for education, and for charitable donations.

The Tax-on-Tax Approach

Table 1 shows how the federal and provincial tax computations are linked to basic federal tax under the tax-on-tax approach. The starting point for the calculation of provincial income tax is the basic federal tax (BFT) on which a province can apply only a single tax rate. Provinces are bound by the federal definition of taxable income, the federal brackets and rate structure, and the

federal non-refundable tax credits (the shaded area of the table). Provinces can, however, use tax credits or surtaxes to modify the incidence of income tax on their taxpayers.

Table 1

Federal and Provincial Tax Calculations, Tax-On-Tax System	
Federal tax calculation	**Provincial tax calculation**
(Taxable income	
times	
federal tax rates)	
minus	
(federal non-refundable credits	
times	
federal rate)	
equals	
Basic federal tax	
Basic federal tax	(Basic federal tax
	times
	single provincial tax rate)
plus or minus	plus or minus
other federal amounts*	other provincial amounts*
equals	equals
Net federal tax	**Net provincial tax**

* Surtaxes or tax credits

Source: Adapted from Canada, Department of Finance, *Personal Income Tax Coordination: The Federal-Provincial Tax Collection Agreements* (Ottawa: the department, June 1991), 17.

PROVINCIAL AND FEDERAL CONCERNS WITH THE EXISTING TCAs

As the above discussion shows, social and economic developments have greatly influenced the policy needs of both the federal and provincial governments as well as the balance between these differing needs. As a result, the TCAs have evolved over time. Both levels of government have agreed to TCA changes that provided a new balance between their respective needs consistent with their naturally differing objectives. The following provides a snapshot of provincial and federal concerns with the TCA structure that has existed until recently.

Provincial Concerns with the Existing TCAs

Some provinces felt that the existing TCAs unduly restricted their ability to determine personal income tax policy. For example, reliance on the BFT restricts the flexibility of provincial personal income tax policy because the BFT incorporates both the federal marginal tax rate structure and the federal non-refundable tax credit block. Provincial tax incidence and policy are automatically tied to the federal marginal tax rate structure and to the level and direction of federal support for social and economic policy through tax credits. Such credits include, for example, those for spouses, seniors, the disabled, charitable donations, and medical and education expenses.

While the current tax arrangements provide a degree of flexibility in provincial tax policy through the use of surtaxes and low-income tax reductions, some provinces have felt that these options are cumbersome and insufficient.

As mentioned earlier, under the personal and corporate income TCAs the federal government administers various special measures for provinces, provided that those measures meet the 1981 MacEachen guidelines. But experience shows that these broad guidelines have been difficult to apply in particular situations. The provinces have expressed difficulties with the transparency of the guidelines, which causes uncertainty over what might be administered by the federal government.

Federal Concerns with the Existing TCAs

Provinces have not been alone in their concern about some aspects of the existing TCAs. The federal government's concerns can be divided broadly into two groups:

1. The existing federal and provincial roles and their interaction in the income tax area have many undesirable effects on tax rates, suggesting a need for improvement.

2. The federal government has also been uncomfortable in the application of the MacEachen guidelines, sharing provincial concerns that they are not transparent and are difficult to apply.

Table 2 illustrates the first of these two federal concerns. The table presents effective marginal tax rates for a one-earner family across provinces. Examined horizontally, the table shows the effective provincial tax rates for each income class; read vertically, it provides a snapshot of a single province's tax rate for various income classes. Regardless of the way the table is examined, one conclusion jumps out: for no apparent social or economic reason, marginal tax rates in Canada are highly uneven.

Table 2

Effective Marginal Tax Rates for a Typical One-Earner Family of Four at Selected Income Levels, by Province – 1998

Income	Province										
	Nfld.	PEI	NS	NB	Que.	Ont.	Man.	Sask.	Alta.	BC	Avg.*
5,000	6	6	6	6	-24	6	5	-24	6	6	0
10,000	6	6	6	6	-24	6	5	6	-2	6	2
20,000	34	32	22	32	63	25	37	93	34	49	42
30,000	59	57	61	57	63	65	60	58	57	70	61
40,000	49	47	46	47	50	43	52	48	47	45	47
50,000	49	47	46	47	58	43	51	50	44	45	48
60,000	56	55	52	49	59	51	57	56	50	51	54
70,000	58	55	53	54	53	55	55	57	46	56	54
80,000	53	50	48	54	53	50	50	52	46	51	51
90,000	53	50	50	54	53	50	50	52	46	54	51
100,000	53	50	50	50	53	50	50	52	46	54	51

*Simple average of all provinces at each income level.

Source: Canada, Department of Finance, internal document.

With respect to the second concern, the MacEachen guidelines, the federal government played an uncomfortable role in imposing an imprecise set of criteria that affected provincial flexibility and created, at times, serious irritants. This was particularly so for the criterion concerning the economic union. Clearly this guideline represented the federal responsibility to protect the economic union. Federal judgements in this regard may not have been perceived, however, as having the same impact from a provincial point of view. Provinces may not have accepted the federal assessment of provincial measures as being harmful for the economic union; they may have felt that the federal protection provided against such measures did not warrant the loss of their tax policy flexibility; or they may have viewed any negative impact of a provincial action to be too small to be relevant.

The federal government often received requests to administer new provincial tax measures, in particular new tax credits, within days of when the province wished to announce such measures in its budget. This left little or no time for a proper assessment or consultation with other parties. The fact that provinces often expect confidentiality before an announcement further constrained any consultations.

RECENT IMPROVEMENTS TO THE TCAs

In dealing with issues related to the functioning of the TCAs, the federal and provincial governments face the same challenge they have faced many times since the original tax rental agreements in 1941 – how to adjust the TCAs so that they continue to give provinces the policy flexibility they require in meeting their regional needs while, at the same time, allowing a degree

of policy harmonization and co-ordination that the federal government considers important from the perspective of national outcomes.

The federal and provincial governments have had many discussions in recent years on finding mutually beneficial ways to modify the TCAs. As a result, a number of changes have emerged that are expected to improve the federal-provincial tax relations considerably. These changes, not all related to the TCAs, can be grouped into four elements, with the elements providing an integrated mechanism to further both provincial and federal objectives.

1. Greater flexibility of provincial tax policy will result from the use of a tax-on-income approach under the TCAs, satisfying specialized needs that certain provinces may have.

2. New guidelines have been established for the federal collection of provincial taxes, allowing further flexibility in provincial tax policy. An important new principle in the guidelines is that the costing structure encourages policy harmonization and co-ordination.

3. Revenue Canada will be replaced with a more efficient Canada Customs and Revenue Agency (CCRA) that will reduce the cost of tax collection and offer provinces increased and improved service to reduce or eliminate federal-provincial overlap and duplication.

4. The Federal-Provincial Committee on Taxation discusses tax policy changes before they are put into place, so that their regional and national consequences are better understood, and governments will take this analysis into account in modifying policies before they are implemented.

The Tax-on-Income Option

At the December 1997 meeting of Canada's finance ministers, the federal minister of finance accepted the longstanding request of some provinces to allow them to apply provincial tax directly on taxable income, rather than as a percentage of BFT[3]. Each province is given the option of choosing a tax-on-income approach or retaining the current tax-on-tax approach[4]. The possibility of using a tax-on-income approach allows the provinces and territories to further pursue their social and economic policy objectives through the personal income tax system, within the TCAs[5].

The following are the key features of the proposed tax-on-income option[6].

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[3] The tax-on-income option would address the provinces' desire to shelter their personal income tax revenues from federal tax changes.

[4] The new Alberta budget, announced on March 11, 1999, proposed to move Alberta to a tax-on-income basis and on September 1, 1999 the province announced an implementation date of January 1, 2001.

[5] With reference to Figure 1, it is the view that a small inward shift of the dashed line of circle A would permit certain provinces to move their dashed line B substantially leftward, raising total national and regional welfare.

[6] Details can be found in Canada, Federal-Provincial Committee on Taxation, *Tax on Income*, Report prepared by the Federal-Provincial Committee on Taxation for presentation to Ministers of Finance, October 1998.

Provincial policy flexibility

1. Each province or territory may determine if, and when, it wants to move to a tax-on-income system, or if it prefers to remain in the current tax-on-tax system.

2. Each province or territory would have additional flexibility to design its personal income tax policies. Under a tax-on-income system, a province or territory would

   (a) determine the number of tax brackets and the tax rate applying to each bracket (including the possibility of a zero rate on a first bracket);

   (b) be able to have its own distinct block of non-refundable tax credits (to be multiplied by the lowest non-zero provincial tax rate); and

   (c) determine to what extent it will use surtaxes, low-income tax reductions, and refundable tax credits.

3. With respect to the distinct block of provincial or territorial non-refundable tax credits

   (a) provinces could supplement federal credits or add any additional unique provincial credits; and

   (b) income testing of any federal credits would not affect the amount of any provincial supplement.

Constraints on provinces

Provinces face minimal constraints under the tax-on-income model. Provinces are required to use the same taxable income base as the federal government. The purpose is to have, at least, a uniform tax base across the country on which taxes are levied. Different taxable income bases across the country would create serious economic distortions, as some income might be taxed in one province and not in another. Furthermore, having the same base ensures that there will be no double taxation of multi-jurisdictional taxfilers.

Table 3 illustrates how, under the new tax-on-income approach, the federal and provincial tax computations would be linked to federal taxable income. Under the tax-on-income approach, the starting point for the calculation of provincial income tax is federal taxable income. As under the tax-on-tax approach, provinces would still be bound by the federal definition of taxable income (the shaded area), but would be able to set their own tax brackets and tax rates. In addition, provinces would be able to establish their own distinct block of provincial non-refundable tax credits[7].

Given the need to develop new systems, and the year 2000 problem, the earliest date a province may be able to move to the tax-on-income system is January 2001.

[7] A block of provincial non-refundable tax credits would build on the federal credit block by taking the gross federal credits as a base and adding supplemental provincial credits.

Table 3

Federal and Provincial Tax Calculations, Tax-On-Income System	
Federal tax calculation	**Provincial tax calculation**
(Federal taxable income	(Federal taxable income
times	times
federal tax rates)	multiple provincial tax rates)
equals	equals
Federal tax	**Provincial tax**
Federal tax	Provincial tax
minus	minus
(federal non-refundable credits	(provincial non-refundable credits
times	times
federal rate)	provincial rate)
equals	equals
Basic federal tax	**Basic provincial tax**
Basic federal tax	Basic provincial tax
plus or minus	plus or minus
other federal amounts *	other provincial amounts *
equals	equals
Net federal tax	**Net provincial tax**

* Surtaxes or tax credits

Source: Adapted from Canada, Department of Finance, *Personal Income Tax Coordination: The Federal-Provincial Tax Collection Agreements* (Ottawa: the department, June 1991), 27.

Guidelines for the Federal Administration of Provincial Taxes

Following a discussion at the December 1997 meeting of finance ministers, new guidelines came into force in January 1998 for the types of taxes and measures the federal government will administer on behalf of provincial governments, and their cost. These new guidelines greatly enhance the flexibility of provincial tax policy.

The guidelines also encourage provinces to move toward policy harmonization and co-ordination through the use of the costing structure. The federal government will subsidize the federal collection of harmonized taxes by not charging provinces the actual cost of collection, and will not subsidize provinces for other taxes (that is, it will charge them the actual cost of tax

collection).[8] For example, under the new guidelines, provinces would pay for any incremental costs associated with a tax-on-income system.

According to the guidelines[9]:

1. Revenue Canada or CCRA will administer just about any reasonable provincial tax structure (rates, brackets, non-refundable tax credits, and refundable tax credits).

2. Any such provincial tax will be administered

   (a) free of charge or at incremental cost under federal-provincial policy harmonization agreements (the tax will be free of charge if it mimics the federal tax, and at incremental cost otherwise); at present, this costing will apply to the TCAs and CITCAs;

   (b) at full cost recovery (or average cost) for all other tax collections.

The guidelines provide flexibility beyond what is available under the tax-on-income option. Provinces may use tax credits to alter, for the purpose of calculating provincial income tax, the value of various federal expense-related deductions and non-refundable credits to achieve province-specific social and economic objectives. Such flexibility for modification is not allowed on the income side of the calculation for taxable income for a simple reason: such flexibility would allow a province to impose differential tax rates within a province on various sources of income, again with potentially large negative economic effects beyond the provincial borders. As an example, such flexibility would allow a province to establish a very low tax rate on capital income, compared with other sources of income, attracting the highly mobile capital from other provinces, which would negatively affect the national economy.

Canada Customs and Revenue Agency

The federal government announced its intention to create the Canada Customs and Revenue Agency (CCRA) in the 1996 speech from the throne. The creation of the agency will provide an opportunity to reduce much of the duplication in tax administration between the federal and provincial or territorial governments, as well as to foster a better working relationship between the two levels of government.

The creation of the agency is based on two key objectives.

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[8] With reference to Figure 1, the new guidelines encourage provinces to enter into TCA-type agreements in other tax fields, thus generating national and regional benefits similar to those with the TCAs.

[9] Generally, provincial or territorial taxes will be administered if (1) they are legally valid; (2) they adhere to basic principles – that is, they do not jeopardize the system of self-assessment, they do not involve double taxation, and they contain generally accepted standards for fairness; (3) Revenue Canada or the Canada Customs and Revenue Agency and the province or territory can arrive at mutually acceptable contractual arrangements; and (4) they do not impose different tax rates on different sources of income which would lead to problems similar to "poaching" from other provinces.

First, the agency will administer tax, trade, and customs programs more efficiently if it is organized and managed according to its own tailored systems, rather than those that apply to the federal public service as a whole. It will be better placed than a traditional government department to respond to client needs, provincial and territorial requirements, and a constantly changing business environment.

Second, a single, dedicated agency for the administration of federal, provincial, and territorial revenue programs and other related programs is likely to reduce the cost of collecting taxes and the cost of complying with Canadian tax laws, since the marginal cost of tax collection is probably lower than the average cost. It is also likely that there are economies of scale. For both these reasons, the cost to a province if it were to collect its own personal income taxes would likely be higher than the federal cost. As well, dealing with one agency instead of two will reduce the cost of compliance for taxpayers.

The Federal-Provincial Committee on Taxation

The Federal-Provincial Committee on Taxation, with the assistant deputy minister, Tax Policy, Department of Finance Canada, as chair, provides a forum in which the federal and provincial governments may discuss federal and provincial tax policy changes and examine their consequences for the national and provincial economies. These discussions can be extremely useful in providing an exchange of information, with the potential of guiding policy development in an appropriate direction for the benefit of both national and regional economies. At regular meetings, officials from both levels of government discuss proposed federal and provincial tax policies thoroughly to examine their appropriateness and determine their national and regional consequences. The purpose is to ensure that policy changes are regionally and nationally effective and appropriate. These discussions then form the basis for meetings in which ministers of finance shape policies.

CONCLUSIONS

In a federation such as Canada, it is natural for the federal and provincial governments to have different objectives: the federal government has to consider the overall national economy while a province will focus on the provincial economy. The federal and provincial governments also have a shared goal, however – that the national economy should function well and that there should be as little overlap and administrative duplication as possible to reduce costs. These common interests have brought the federal and provincial governments together in the past through the TCAs.

The TCAs have worked well. As stated in the 1997 OECD *Canada Review*: "The benefits of decentralised taxing authority can be achieved without sacrificing a harmonised and administratively simple tax system by federal-provincial tax collection agreements. This has been a success story in the case of income taxes in Canada"[10]. The TCAs have worked well because evolution has been their constant feature.

[10] Organization for Economic Co-operation and Development, *Canada Review* (Paris: OECD, 1997), 96.

Major new improvements to the TCAs have recently occurred, along with other complementary steps to meet both federal and provincial tax policy objectives. There are four aspects to this change. First, provinces that make use of the tax-on-income option would have more tax policy flexibility through the application of provincial tax directly on taxable income, rather than as a percentage of the basic federal tax. Second, the new administrative guidelines allow just about all provincial taxes to be collected by the federal government, with minimal constraints. To achieve the objectives of federal policy harmonization and co-ordination, however, the costing structure subsidizes the federal collection of harmonized taxes, but not that of unharmonized taxes. Third, the new CCRA will significantly reduce duplication in tax administration between the federal and provincial or territorial governments, and will foster a better working relationship between the two levels of government. Finally, with a view to improving policy co-ordination, the Federal-Provincial Committee on Taxation ensures that major federal and provincial tax policies are discussed thoroughly, before they are introduced, from the perspective of both their national and their regional consequences.

Annex 2

TAX ON INCOME

October 1998

Report prepared by the Federal-Provincial Committee on Taxation
For presentation to Ministers of Finance

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EXECUTIVE SUMMARY

Both the federal and provincial governments collect personal and corporate income tax from Canadians. In all provinces but Québec, the federal government collects provincial personal income tax (PIT) on behalf of the provinces, in accordance with Tax Collection Agreements (TCAs). Under the terms of these Agreements, provincial PIT is calculated by applying a single provincial tax rate to basic federal tax (i.e., "tax on tax"). Provinces then adjust this preliminary amount by applying surtaxes, flat taxes or tax reductions, where they exist.

The existing TCAs place a strong emphasis on tax harmonization and simplicity for taxpayers and employers. The benefits of this harmonization are significant – a common national tax base, an intergovernmental tax system that reduces bias in economic decisions, and an efficient administrative apparatus.

However, using tax on tax to harmonize the tax system constrains the flexibility of those provinces that want to use the tax system to meet their own social and economic priorities. Faced with such constraints, these provinces have reacted with a complex array of special measures to meet their policy objectives within the tax on tax framework. As a result, in these circumstances, some of the potential benefits of the harmonized tax on tax system may be offset by increased complexity.

To address provincial flexibility and complexity concerns, the federal government agreed in December 1997 to amend the TCAs to allow those provinces that so desired to levy provincial PIT directly on taxable income (i.e., "tax on income"), rather than as a proportion of basic federal tax. Tax on income is seen by some provinces as the necessary alternative to address their need for a more direct means of utilizing the tax system to achieve the social and economic policy requirements of their taxpayers.

Under the tax on income option:

- A province must keep the federal definition of taxable income as the base upon which to levy provincial PIT.
- A province could set its own tax brackets and rates.
- A province would retain access to surtaxes and to low-income tax reductions.
- A province could establish a distinct block of provincial non-refundable tax credits, to be multiplied by the lowest non-zero provincial tax rate.
- A province would not be restricted in the number of refundable tax credits they could offer.

The existing tax arrangements would continue, allowing provinces individually to determine if, and when, they elect to move to this new tax on income option. It is important for each province to consider this option in light of its own circumstances.

TAX ON INCOME

Purpose

During discussions at the December 1997 meeting of Canada's Finance Ministers, the federal government agreed to enter into new arrangements with interested provinces that would remove some of the restrictions in the current federal-provincial Tax Collection Agreements. These new arrangements would continue to operate within the context of a national income tax system.

The new system would increase provincial personal income tax flexibility within the existing Tax Collection Agreements by computing provincial tax directly on taxable income, rather than as a percentage of basic federal tax. Each province can elect to accept this option, and the increased flexibility it provides, if it considers it will benefit its taxpayers.

This paper was prepared jointly by federal and provincial officials from the provinces that have Tax Collection Agreements for personal income tax with the federal government (all provinces except Québec). This does not imply that all provinces are in favour of applying tax on taxable income, simply that the option is available to all. This paper outlines the key features of this new option for provinces.

Background

The Tax Collection Agreements (TCAs), put in place in 1962, are the administrative mechanism that provide harmonization of tax structures and respect both the federal and provincial governments' constitutional right to impose personal and corporate income taxes.

All provinces and territories, with the exception of the province of Québec, have TCAs with the federal government to administer and collect the provincial income taxes imposed on personal income (PIT). For taxes imposed on corporate income (CIT), all provinces and territories except Québec, Ontario and Alberta have TCAs with the federal government.

Under the terms and conditions of the TCAs governing PIT, the federal government (through Revenue Canada) collects and administers provincial income taxes, in conjunction with federal income tax, and pays provinces the value of the income tax assessed. Each province imposes a single rate of personal tax, calculated as a percentage of basic federal tax (i.e., "tax on tax"), and maintains provincial Income Tax Acts that parallel the federal *Income Tax Act*.

The TCAs have evolved since 1962, and now include various special measures such as surtaxes, flat taxes, tax rate reductions and provincial tax credits. The Agreements provide a degree of consistency and harmony in an integrated national tax system.

Today's national PIT system comprises the following:

- a common definition of taxable income;

- a common method of determining provincial residency and allocating taxable income among provinces;
- a common set of federal tax brackets and rates levied on individuals; and,
- a common definition of what constitutes deductions or credits for such things as support for the family, education and charitable donations. It also permits consistent treatment of corporate distributions to individuals.

Under the current tax on tax system, the federal and provincial tax computations are linked to basic federal tax, as follows:

Federal and Provincial Tax Calculations
Tax on Tax System

Federal	**Provincial**
Taxable Income	
x Federal tax rates	
= Federal tax	
- (Federal non-refundable credits x Federal rate)	
= Basic federal tax	Basic federal tax
	x Provincial tax rate
	= Basic provincial tax
+ / - Other federal amounts (surtaxes or tax credits)	+ / - Other provincial amounts (surtaxes or tax credits)
= Net federal tax	= Net provincial tax

Limitations of the Current Tax Arrangement

Some provinces feel the current tax arrangements unduly restrict their ability to determine PIT policy. For example, the federal government has the responsibility for determining the non-refundable tax credit block.

Reliance on basic federal tax, which incorporates the federal marginal tax rate structure and the federal non-refundable tax credit block, also restricts provincial PIT policy flexibility. Provincial tax incidence and policy are automatically tied to the federal marginal tax rate structure and to the level and direction of federal support for social and economic policy through tax credits. Such credits include, for example, those for spouses, seniors, the disabled, charitable donations and medical and education expenses.

While the current tax arrangement provides some provincial flexibility through the use of surtaxes and low-income reductions, these options are cumbersome. As well, in a few instances, measures have been inconsistently applied across provinces.

Tax on Income

The levying of provincial-specific tax rates on taxable income, or simply "tax on income", is seen by some as the next logical step in the evolution of the TCAs. A shift to tax on income would reduce some provinces' need to pyramid tax measures in order to use the tax system to achieve their social and economic policy objectives.

A major redesign of the tax system, such as that requested by provinces, must be comprehensive and durable. It should also respond to those provincial desires for increased flexibility to establish independent social and economic policies that respond to changing provincial circumstances.

Design and Operation

Under the tax on taxable income option, provinces would continue to use the federal definition of taxable income, thus ensuring a **common tax base**. Use of a common formula for allocating the income of multi-jurisdictional tax filers requires use of a common tax base to avoid confusion and undue complexity.

The tax on taxable income option allows provinces to establish a **unique tax structure** based on provincially determined tax brackets and rates (including, if desired, a zero rate on a narrow first bracket) set independently of the federal brackets and rates. The ability to set tax brackets and rates gives provinces more direct ability to alter tax progressivity, taking into account their own unique circumstances. Provinces could choose to retain existing low-income reductions or surtaxes, but would combine any existing flat taxes into the new bracket and rate structure.

This option would also allow provinces to create a distinct block of **non-refundable tax credits**, to be multiplied by the lowest non-zero provincial tax rate. A distinct provincial credit block, which would appear on the provincial tax form, is a more direct way for provinces to use the tax system to achieve social and economic policy objectives. It would let provinces replace cumbersome low-income tax reduction calculations with income-tested credits.

Provinces would retain all existing federal non-refundable tax credits. Therefore, the provincial credit block would include all the current (i.e., 1997) federal credits plus additional, unique provincial credits. These additional provincial credits would be limited to those that Revenue

Canada would be able to administer, and may include federal credits that have been eliminated (for example, the credit for children).

A separate provincial credit block would build on the federal credit block by taking the gross federal credits that a taxpayer is eligible for as a base, and adding supplemental provincial credits. Provinces agree that the value of a gross provincial credit could not be less than the minimum of:

- the 1997 value of the corresponding federal credit; and
- the value of the corresponding federal credit in the current year.

For example, the current federal basic credit is $6,456[1]. Under the tax on income option, if the federal government increased the credit to $7,000, provinces could decide whether to maintain the provincial credit at $6,456 (plus any provincial supplement) or match the federal increase. Similarly, if the federal amount were reduced to $6,000, a province would have the option of reducing the provincial credit, retaining the $6,456 level or increasing the provincial credit.

For federal credits that are expenditure based, the proposal is that the gross provincial credit would be no less than the gross federal credit in each year (i.e., CPP premiums, EI contributions, tuition fees, medical expenses and charitable donations).

The provincial supplements to federal credits would not be affected by federal income testing of the relevant federal credit. For example, supplemental provincial amounts for seniors, spouses and dependants would be available to all taxpayers who are eligible to claim the federal credits.

Provincial credits would always use the same definitions as federal credits, where federal definitions exist. For example, a child would be defined the same way for both provincial and federal purposes. Where there is no corresponding federal credit, provinces would specify the provincial credit amount.

The total value of provincial credits would be multiplied by the lowest non-zero provincial tax rate to determine the net provincial non-refundable tax credit amount. The only exception would be the credit for charitable gifts, which is credited at the lowest and highest rates federally. Provinces have agreed to retain this two-tier credit structure. Thus, donations below a threshold would be credited at the lowest non-zero provincial tax rate and the balance would be credited at the highest provincial tax rate.

For those provinces that want to use the tax system to further pursue their own economic and social objectives, establishing a distinct provincial credit block has two advantages:

- First, while continuing to tie basic provincial support to the federal credit block, it would allow provinces to supplement federal support, improving their flexibility in undertaking

[1] The 1998 federal budget introduced a supplementary personal tax credit of $500 for low-income tax filers. Provinces, under tax on income, would not automatically match this amount; it would be up to each province to decide.

social policy. Whether a province provides a supplement and the value of each supplement would become provincial policy decisions, as would the choice whether or not to match a federal credit increase or decrease.

- Second, it would increase the transparency of provincial tax systems by clearly showing taxpayers the level of provincial support for the various credit block components.

Under tax on income the federal and provincial tax computations, after the determination of taxable income, could parallel each other, as follows:

Federal and Provincial Tax Calculations
Tax on Income System

Taxable Income

x Federal tax rates	x Provincial tax rates
= Federal tax	= Provincial tax
- (Federal non-refundable credits x Federal rate)	- (Provincial non-refundable credits x Provincial rate)
= Basic federal tax	= Basic provincial tax
+ / - Other federal amounts (surtaxes or refundable credits)	+ / - Other provincial amounts (surtaxes or refundable credits)
= Net federal tax	= Net provincial tax

Impact on Employers

Businesses and individuals in provinces that choose to implement the tax on income option will undergo a period of transition and adjustment, as is the case with any payroll change. The extent of the impact on both employers and individuals will depend on the changes that a province chooses to introduce under tax on income.

For example, if a province chooses to make use of the maximum flexibility of the tax on income option by introducing its own unique block of provincial credits, employees will need to file a separate provincial tax credit claim form similar to the federal TD1 form. Employers will be called upon to assist employees with this task. Employers (and payroll service bureaus) will need to reprogram payroll software or internal pay systems.

For a province that chooses an approach under the tax on income option that closely mirrors its current system, by not expanding the number of brackets or range of credits, transition issues will be substantially reduced.

Timing

Planning for the introduction of the tax on income option would necessitate an appropriate development period for governments, employers, and individuals. Resources must be set aside to update and test systems changes. It will also be necessary to take into consideration the necessary adjustments to information technology systems resulting from the Year 2000 computer problem. To ensure an orderly and manageable introduction for a provincial tax-on-income system, each of these factors would need to be taken into account.

Summary of the Option

Tax on income is an option that is available to provinces. However, not all provinces may want to move to a tax on income system, given their own unique circumstances. Some provinces might choose to levy tax on income while other provinces continue the current system of levying tax on tax.

The tax on income option could give certain provinces the flexibility they may want to establish a unique provincial PIT structure to further their social and economic goals using the personal income tax system. Under this option:

- A province must keep the federal definition of taxable income as the base upon which to levy provincial PIT.

- A province could set its own tax brackets (including, if desired, a zero rate on a narrow first income bracket) and tax rates.

- A province would retain access to surtaxes and to low-income tax reductions with either individually-based or family-based income testing.

- A province could establish a distinct block of provincial non-refundable tax credits, to be multiplied by the lowest non-zero provincial tax rate.

    - The provincial credit block would include all the current (i.e., 1997) federal credits plus additional, unique provincial credits. A province could also supplement federal credits, but would not be required to provide corresponding credits for new federal credits introduced after 1997.

    - A province would work with the federal government to explore the potential for reducing provincial reliance on low income tax reductions by expanding the use of income testing for the supplementary amounts of the provincial non-refundable tax credits.

- This option offers provinces a range of flexibility with respect to the use of a distinct provincial credit block.

- A province would not be restricted in the number of refundable tax credits they could offer.

The existing TCAs will continue, allowing provinces individually to determine if, and when, they elect to move to the new system. It is important for each province to consider this option in light of its own circumstances.

Appendix A
Sample Provincial Non-Refundable Tax Credit Block

	1997 Federal credits			Provincial credits
	Amount	Income tested?	Transferable?	Amount
Basic	$6,456			$6,456 + prov. supp. = prov. amt.
Age	$3,482	Yes	Yes	fed. amt. + prov. supp. = prov. amt.
Spousal	$5,380	Yes		fed. amt. + prov. supp. = prov. amt.
Equivalent-to-spouse	$5,380	Yes		fed. amt. + prov. supp. = prov. amt.
Infirm dependants	$2,353	Yes		fed. amt. + prov. supp. = prov. amt.
Canada Pension Plan	actual			fed. amt. + prov. supp. = prov. amt.
Employment Insurance	actual			fed. amt. + prov. supp. = prov. amt.
Pension income	$1,000		Yes	$1,000 + prov. supp. = prov. amt.
Disability	$4,233		Yes	$4,233 + prov. supp. = prov. amt.
Disabled dependent	$4,233			$4,233 + prov. supp. = prov. amt.
Tuition fees	actual		Yes	fed. amt. + prov. supp. = prov. amt.
Education	$150/mth		Yes	fed. amt. + prov. supp. = prov. amt.
Medical expenses	actual	Yes		fed. amt. + prov. supp. = prov. amt.
Charitable gifts	actual			fed. amt. + prov. supp. = prov. amt.
Child	--			prov. amt.

Appendix B
Technical Details

Implementation of tax on income would require examination of numerous technical issues within the tax system. Federal and provincial officials are working together to find solutions. Below are approaches to deal with several of these issues.

Allocation of Business Income Across Provinces

Where an individual earns business income in more than one province, the income is allocated among provinces according to a formula. The formula determines the proportion of the individual's total business income subject to tax in each province and allocates basic federal tax among the provinces in which business income is earned. The individual then multiplies the amount of basic federal tax allocated to each province by the appropriate provincial tax rate.

Under tax on income, business income could be allocated according to a similar formula. However, basic federal tax would no longer be the appropriate basis on which to distribute the provincial tax liability, and allocating taxable income between provinces would no longer be appropriate since the individual would be taxed at the lowest tax rate in each province. As a result, a notional provincial tax calculation could be used in order to ensure that taxpayers earning business income in more than one province would pay an appropriate amount of provincial tax based on their total income.

Alternative Minimum Tax

The alternative minimum tax applies a minimum tax to individuals who reduce their regular tax below a certain level through the use of special deductions, exemptions and credits. Under the current tax on tax system, provincial tax is calculated on the alternative minimum tax amount where this is the tax payable by an individual. Similarly, provinces automatically provide a credit for the carry-over of alternative minimum tax amounts from prior years.

Under tax on income, provinces could levy alternative minimum tax at a rate of 50 per cent of the additional federal tax due to alternative minimum tax and could provide a separate provincial refundable credit (also at rate of 50 per cent of the federal credit). This could be a practical approach for the case of multiple jurisdiction returns.

Dividend Tax Credit

The dividend tax credit mechanism provides for the integration of the personal and corporate income tax systems, resulting in dividend income from small Canadian controlled private corporations bearing approximately the same amount of tax as if the corporate income had accrued directly to the shareholder.

Under tax on income, provinces would provide a provincial dividend tax credit to assure the appropriate integration of business and personal income.

Overseas Employment Tax Credit

The overseas employment tax credit provides relief from Canadian taxation for income earned when working on certain projects abroad. Its purpose is to help Canadian contractors preserve their competitive position with respect to foreign contractors.

Under tax on income, provinces could provide an overseas employment tax credit that parallels the federal calculation.

Charitable Donations Tax Credit

The federal charitable donations tax credit has a two-tiered structure:

- a credit at the lowest marginal tax rate is provided on the first $200 of donations, and
- a credit at the highest marginal tax rate is provided on donations in excess of $200.

The provincial charitable donations credit under tax on income would parallel the existing two-tiered federal credit.

Medical Notch Provision

The medical notch provision enables a taxpayer to claim the medical expenses for a dependent for whom the taxpayer would have claimed a personal amount if that dependant's income had not been too high.

No explicit provincial calculation would be needed in order to incorporate this measure into the provincial tax system.

Part Year Residents and Bankrupt Individuals

Special rules determine the extent to which part year residents and bankrupt individuals may claim tax credits. Under the tax on income model, because the pro ration of tax credits would be done automatically, no explicit provincial calculation would be required.

CPP/QPP Lump Sum Payments

A special election enables recipients of CPP/QPP lump sum benefits to include the benefits in the year to which they relate, even if they are received in a different year.

Under tax on income, an approach is that provinces explicitly provide this election, by means of a calculation that parallels the federal one.

Lump Sum Pension Payments

A special transitional rule provides for the grandfathering of a pre-1972 rule, which allowed for a form of averaging of lump sum pension payments.

Under tax on income, an approach is for provinces to explicitly provide the election, by means of a calculation that parallels the federal one.

Trusts

Under the federal tax system, trusts are treated as individuals, but are not entitled to personal tax credits. Most inter vivos trusts (those created and taking effect during the lifetime of the creator) are subject to tax at the highest marginal rate; testamentary trusts (those created in a will) and certain grandfathered inter vivos trusts are subject to the progressive rate structure.

Under tax on income, an approach is for provinces to continue to parallel the federal treatment of trusts. This means that provinces would levy their top marginal rates on inter vivos trusts and apply their rate structure to testamentary and grandfathered inter vivos trusts.

Appendix C
Sample Timetable for Implementation of Tax on Income

Implementation for the 2001 taxation year would give rise to the following time-lines:

1998 to 1999	Development of parameters by provinces for their personal income tax systems.
August 1999	Introduction of provincial legislation.
September 1999 to October 2000	Analyses, research, focus testing and system development and testing by Revenue Canada.
December 2000	Distribution of withholding tables to employers.
December 2000 to December 2001	Forms design and testing and guide preparation by Revenue Canada.
January 2002	Distribution of forms and guides to tax filers. Tax filing begins.

Annex 3

TAX ON INCOME TECHNICAL ISSUES

Federal and provincial officials have resolved a number of technical issues that remained outstanding from the October 1998 report on *Tax on Income* (Annex 2) as well as a few other issues that arose in subsequent discussions on tax-on-income. These solutions are summarized below.[1]

Alternative Minimum Tax

The purpose of the alternative minimum tax is to limit the extent to which individuals can reduce or eliminate tax through the heavy use of tax deductions. In the context of tax-on-income, the following two options were agreed upon:

(a) taking a percentage of the additional federal tax attributable to the alternative minimum tax and adding this amount to the regular provincial tax; or

(b) applying the provincial tax structure to the federal net adjusted income used for alternative minimum tax purposes. Provinces would apply their lowest non-zero rate to the federally-defined adjusted taxable income base and provincial non-refundable credits would then be subtracted from the gross minimum amount to obtain the alternative minimum tax owing.

Dividend Tax Credit

The dividend tax credit mechanism provides for the integration of the personal and corporate income tax systems, resulting in dividend income from small corporations bearing roughly the same amount of tax as if the corporate income had accrued directly to the shareholder.

Under the tax-on-tax regime, provinces lack the necessary tools to ensure appropriate integration of their corporate and personal tax systems as regard to the treatment of small business income. However, under tax-on-income, provinces will be able to provide a dividend tax credit set at a rate that achieves integration of the corporate and personal tax systems, with an appropriate transition period.

Overseas Employment Tax Credit

The overseas employment tax credit provides tax relief to Canadians working on certain projects abroad. Its purpose is to help Canadian businesses operating abroad by making it easier for them to employ Canadians at competitive rates of pay.

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[1] This summary note is based on Technical Issues on Tax on Income, discussed at the Tax Committee meeting in December 1999.

The following two options were agreed upon:

(a) apply the average provincial tax rate to the federal tax base applicable in this situation, analogous to the federal calculations; or

(b) apply the percentage reduction in federal tax achieved by the overseas employment tax credit to the provincial tax otherwise payable.

CPP/QPP Lump-sum Payments and Lump-sum Pension Payments

A special election allows recipients of CPP/QPP lump-sum benefits to have the payments taxed in the year(s) to which they relate. Also, a special transitional rule introduced with the 1971 tax reform includes a grandfathering provision that allows certain lump-sum pension and deferred profit sharing plan payments to be averaged over a number of years.

Two options for provinces to deal with these lump-sum payments are available:

(a) follow the federal re-profiling of income because of lump-sum payments, apply the provincial tax structure on the revised income stream, and then make an adjustment to tax liabilities in the current year; or

(b) reduce provincial tax on the payments by the same percentage as the federal reduction on the payments.

Trusts

Under the federal tax system, trusts are treated as separate taxpayers and taxed as individuals, except that they are not eligible for personal tax credits. Testamentary trusts (created as a consequence of the death of an individual) are taxed according to the same graduated rate structure as individuals. On the other hand, most *inter vivos* trusts (created and taking effect during the lifetime of the creator) are subject to the tax at the highest marginal tax rate.

Provinces moving to tax on income will provide similar treatment by levying their top marginal rates on *inter vivos* trusts and applying their rate structure to testamentary trusts.

Income-splitting with Minor Children

The 1999 federal Budget introduced a measure on income splitting with minor children in order to discourage certain types of activities undertaken to avoid the progressive tax rate structure. The proposed measure consists of a special tax at the top marginal rate to be imposed on certain types of income of individuals under age 18.

Similarly, provinces moving to tax-on-income will add to provincial tax otherwise payable an amount equal to the province's top marginal rate times the income adjustments arising from this measure.

Multi-jurisdictional Taxpayers

Where an individual has income from unincorporated business in more than one province, the use of basic federal tax as the base for provincial tax ensures that provincial taxes properly reflect the progressive rate schedules in the relevant provinces. Under tax-on-income, basic federal tax would no longer be the appropriate basis on which to distribute the provincial tax liability, and allocating taxable income between provinces would no longer be appropriate since the individual would be taxed at the lowest tax rate in each province.

Accordingly, under the new tax regime, appropriate provincial weighting requires that a province's rate structure be applied to total taxable income before the provincial share of that income is calculated.

Charitable Donations Tax Credit

The federal charitable donations tax credit applies the lowest marginal tax rate (17%) on the first $200 of donations, and the top marginal rate (29%) on donations in excess of $200. According to the Tax-on-Income paper, provinces moving to tax-on-income will apply the lowest non-zero provincial rate to donations below a threshold (not to exceed $200), and the top marginal rate to donations above that threshold.

The Tax-on-Income paper does not capture all possible situations that may arise, such as a single rate. Provinces adopting a single-tax-rate structure could simply apply that single rate on all donations, or keep a credit rate equal to the top marginal tax rate prevailing before the implementation of tax-on-income for donations above the threshold.

Provinces with multiple tax rates can also keep a credit rate equal to the top marginal tax rate prevailing before the implementation of tax-on-income for donations above the threshold.

Medical Expenses Tax Credit

Where an individual claims medical expenses for a dependant other than a spouse, and the net income of that dependant exceeds the value of the basic personal amount, the individual's claim is reduced. The dependant's medical expenses are clawed-back at a rate of 68% of the dependant's net income in excess of the basic personal amount.

Provinces moving to tax-on-income will have to specify a claw-back provision (threshold and rate) with respect to medical expenses claimed for dependants other than a spouse.

The dependant's income would be income-tested against the provincial basic personal amount. Provinces will need to keep in mind that a claw-back rate over 32 % would give rise to an effective marginal tax rate in excess of 100%.

Ordering of Non-refundable Tax Credits

The non-refundable tax credit block is, in general, built in a manner that maximizes the use of the credits by the taxpayer. Credits appear on the tax form in more or less the following order: credits that cannot be transferred nor carried forward, credits that can be transferred to a spouse or supporting individual, and credits that can be carried forward. This particular ordering ensures that a taxpayer with a low tax liability does not "waste" a credit that he or she did not have to use.

Provinces moving to tax-on-income will need to keep in mind the importance of the order in which they will place existing and new non-refundable tax credits.

Treatment of Transferable Credits

Some federal non-refundable tax credits can be transferred to a spouse or supporting individual. Provinces will need to determine how the equivalent provincial credits will be treated when the dependant person and the supporting individual live in different tax jurisdictions.

Carry-forward Provisions

The unused portion of some federal non-refundable tax credits can be carried forward to future years. This is the case for the tuition and education credits as well as the charitable donations tax credit. Provinces need to address two issues that have been raised with respect to the carry-forward provisions of provincial credits:

- The treatment of credits that were carried over from a tax-on-tax period.

- The treatment of taxpayers who move from one province to another and have carried-over amounts.

Annex 4

December 9, 1997

FEDERAL ADMINISTRATION OF PROVINCIAL TAXES

Postscript: This paper is reproduced exactly as it was presented at the December 1997 meeting of the Ministers of Finance. There has naturally been an evolution of thinking on some of the issues discussed here as a result of federal-provincial consultations, particularly at the meetings of the Federal-Provincial Committee on Taxation. The additional changes provide further flexibility to provinces and lower the federal charge of collecting some of their tax measures. These changes are highlighted, and explained in the footnotes in this note, and incorporated in the note in Section 2 of this paper.

The purpose of this paper is to help stimulate discussion regarding guidelines under which to determine what taxes should be administered for provincial governments. The paper should not be viewed or interpreted as representing an official federal position.

Context

The federal and provincial governments have different roles and responsibilities, which result in the two orders of government having different goals in the area of tax policy.

The provinces have the responsibility for dealing with their local economies and quite naturally desire the tools to do this in as flexible a manner as possible.

The federal government, on the other hand, has responsibility for the proper functioning of the overall national economic union and must, therefore, take into account the economic effects of provincial actions that go beyond the borders of that province.

Despite these differing perspectives, there has been a reasonable degree of harmonization and co-ordination in the areas of personal and corporate income tax, since 1962. The Tax Collection Agreements have undoubtedly been important in this regard.

There are now, however, a number of strains in the arrangements that need to be addressed. In addressing these pressures the process should take into account several factors in arriving at a new arrangement.

Key Facts

In 1995, 21 per cent (Quebec) of the basic federal income tax was outside of the personal income TCAs and 79 per cent (Alberta, Ontario and Quebec) of the corporate taxable income was outside of the corporate TCAs. The tax designs of the provinces outside the TCAs have, however, not differed greatly from the harmonized systems under the TCAs.

There are no explicit harmonization/co-ordination arrangements outside the TCAs in other tax fields, with the exception of the CITCA with New Brunswick, Nova Scotia and Newfoundland and Labrador.

The Provincial Perspective

Membership in the TCAs limits the degree of provincial policy autonomy.

Provinces within the TCAs are subject to federal guidelines before federal administration of a tax is approved (see Box below).

Provinces outside the TCAs can design and administer virtually any tax they wish (subject of course to constitutional and other legal issues).

> A province within the TCA can resort to administering a tax measure itself. However, in practice this is usually difficult because these provinces do not have comprehensive tax administration capacities in the income tax fields.

On the one hand there are benefits to being within the TCAs (free administration for one), but there is also a potential liability (less policy autonomy).

On balance, most provinces have stayed in the TCAs but have concerns.

1981 MacEachen Guidelines

Effective administration -- the tax measure must be capable of being administered in an effective manner in order to preserve the efficiency and credibility of the system. This includes being within the legal jurisdiction of provinces.

Common tax base -- the tax measure must respect the common tax base by not changing the federally-defined personal and corporate income tax bases; and,

Free movement of capital, labour, goods and services -- the tax measure must not impede the free flow of capital, goods, services, and labour within Canada.

The Federal Perspective

The federal government has an uncomfortable role in imposing an imprecise set of criteria that affect provincial flexibility and create, at times, serious irritants that affect other aspects of government relations.

This is particularly the case concerning the economic union criteria. Clearly this guideline represents the federal responsibility to protect the economic union. But federal judgements in this regard may not be perceived as having the same impact from a provincial point of view – i.e. provinces may not accept the federal assessment of measures as having harmful effects for the economic union because provinces may feel that the protection provided does not warrant the loss of policy flexibility or may view any negative impact of a provincial action to be too small to be material.

Requests to administer new provincial tax measures -- in particular new tax credits -- are very often received within days of when a province wishes to announce the measure in a budget.

This leaves little or no time for a proper assessment or consultation with other parties (provinces also often expect confidentiality prior to announcement which is also a constraint on consultation).

Given that the main determinant for approving or rejecting a proposed measure is whether it would have negative effects on other provincial jurisdictions, this lack of input from other provinces is particularly problematic.

The Canada Customs and Revenue Agency (CCRA)

The federal government has proposed converting Revenue Canada into the Canada Customs and Revenue Agency (CCRA).

One of the purposes of this reorganization would be to provide a platform for more effective input from provincial governments into the country's largest and most comprehensive revenue administration.

The CCRA provides both an opportunity and an imperative to clarify the terms and conditions under which there will be federal administration of provincial taxes and programs.

Minimum Set of Criteria under the CCRA

Under no circumstances should CCRA administer provincial taxes that do not satisfy the following principles.

1. Legality – the measure must be within the constitutional parameters of the province, be consistent with the Charter and existing legal jurisprudence, must be clearly authorized by provincial statute and must not violate or impair the fulfilment of international obligations.

2. Agreed Set of Basic Principles—the measure must be consistent with the set of basic principles that both federal and provincial levels of government agree with, which includes the following:

    - Self-assessment – the measure must not jeopardise the system of self-assessment upon which the integrity of the Canadian tax system rests.

- No Double Taxation - the provincial tax should not lead to Canadian taxpayers being taxed on the same income or transaction by more than one province.

3. Mutually Acceptable Contractual Arrangements – Revenue Canada (or the Agency) and provinces must be satisfied that the arrangement reached between the two parties are agreeable. Revenue Canada (or the Agency) in negotiating contractual arrangements with the provinces will take into account the following:

   - Fairness – all provincial measures must meet accepted standards of service that include:

     - Fair redress mechanisms, including impartial reviews
     - Provision of complete information about entitlements and obligations
     - Strict privacy and confidentiality framework
     - Fair processes to gain entitlements and fulfil obligations

   - Feasibility – the measure must not impair the ability of Revenue Canada (or the Agency) to deliver existing taxes or programs.

     While in concept a full cost recovery approach should cover this concern (i.e. a province pays for all required resources) in practice there could be resource constraints at any particular time (especially for audits and information technology officers).

The Economic Union Criterion

The basic criteria above do not address the economic union, which is a primary concern of the federal government.

Is it appropriate for the federal government, either through a federal department or an agency, to administer a provincial measure that is injurious to another province or to the economic union in general?

This question must be balanced by the realization that measures not administered by the federal government can be implemented by provinces on their own, whether in the TCAs or not. Indeed, in tax areas beyond those covered by the TCA, this is already happening. Even within the TCA, provinces have the option of administering portions of their income tax by themselves.

Some practical solution is needed in order to balance the principle of the economic union with the reality that a measure can be implemented whether or not it violates the principle.

Proposed Approach for Discussion

In many international agreements, locational incentives are invariably permitted to allow governments to pursue legitimate economic objectives, though they are often constrained to be as transparent as possible. As such, it is proposed that, in examining which provincial tax measures could or could not be administered, locational incentives would be acceptable as long as they

meet the second key economic union criterion, i.e. non-discrimination. That is, the incentive would be available to anyone, both within the province and outside. For example, a province cannot attempt to lure away firms located in another province with a tax incentive that is not available to firms that are already located in the province. Of course any measure that is only discriminatory against (as opposed to in favour of) residents of the province initiating the measure would be administered.

As such, any provincial tax measure, subject to the minimum criteria described above, would fall into one of three categories. These are described below.

i) Measures that injure the Economic Union

Some taxes or measures could injure the economic union where they impose large negative externalities, specifically in the form of discrimination in application, beyond a province's borders. Theoretically, this tax or measure could be implemented and charged the average social cost, with this being defined as including not only all cost of collecting, but also the negative economic impact of the tax or measure beyond the province's boundary.

For this option to be feasible, those bearing the impact would need to be reimbursed. As well, it would be necessary to develop concrete quantitative measures of the externality. Since transfer and measurement mechanisms are not practicable, actions of this type would simply not be administered.

ii) Measures Not Harmonized

A tax measure would be administered by Revenue Canada (or the Agency) on a full cost recovery basis if it is different from the existing national tax system. Full cost recovery would encompass not only the incremental collection costs, but also the relevant portion of Revenue Canada's (or the Agency's) overhead and support costs. The amount of such costs would of course depend on the nature of the tax to be administered by Revenue Canada (or the Agency).

Revenue Canada (or the Agency) would apply established costing methodology in the determination of full costs. This methodology would incorporate all costs, including accommodation, furniture, equipment, training, supplies and other general operating costs.

The costs in each category would be based on standard Revenue Canada averages except where firm documentation allows location specific costs to be substituted or where it was anticipated that the design features of the requested tax would cost more than the average of existing taxes. Standards would be reviewed annually and changes made when appropriate.

An example of this type of tax measure would be the Saskatchewan M&P tax credit. The measure can clearly be demonstrated to be a locational incentive that is targeted to Saskatchewan companies (it penalizes companies that allocate or increase M&P activity outside the province) but has been viewed as essentially benign by other provinces.

Another example of this would be the B.C. Family Bonus and the Alberta Employment Tax Credit (both have portions that are similar in purpose to the federal CTB but are significantly different in design and thus raise administration costs).[1]

iii) Fully Harmonized Tax Measures

A tax that mimics the existing national tax system would be administered on a zero cost recovery basis. This would include the basic tax-on-tax system currently in place, existing investment tax credits, all fully harmonized taxes (for example, the TCAs) harmonized capital taxes, HST, the collection of HST at the border, or a provincial retail sales tax fully harmonized for collection at the border.

The type of taxes that would fall into this category would be those that are exact replicas of the federal tax system. These taxes would use the definitions and design features of the national system.

An outcome of this proposal would be that certain provincial tax measures for which provinces now pay would be free of charge. Examples include the existing political contributions tax credit[2] and existing LSVCC credits.

Process

Both the federal and provincial governments agree that the current process for deciding on the administrability of provincial tax measures is less than ideal.

The current process could be supplemented to allow for appeals and peer review.

Any new process should allow the opportunity for a province, if it feels its request has not been handled properly, to have their case considered in a forum beyond just the federal government.

As well, if one province objects to another province's measure, it to should have the opportunity to raise the issue in a multi-lateral forum.

In these matters, it could be possible to have the Taxation Committee prepare a report for consideration by Finance Ministers.

[1] Following further discussions, it was agreed that such measures, if they were part of the Tax Collection Agreements, would only be charged the marginal cost, rather than the full cost.

[2] It should be clarified that provincial political contributions tax credits are not harmonized with their federal counterpart.

Annex 5

As at October 5, 1999

Application of Framework for Federal Administration of Provincial Taxes[1]

The federal government will administer, on behalf of the provinces and territories, both harmonized and unharmonized provincial tax measures. As a result, a new framework for the costing of the administration of provincial measures has been developed, which replaces the formula-based fee structure that has been used in the past. The essence of this new framework is that the federal government will subsidize the costs of administration of provincial measures if they are harmonized with the national counterpart. As such, a provincial measure that is fully harmonized with the national system, in a formal policy sense (the Tax Collection Agreements and the Comprehensive Integrated Tax Co-ordination Agreements), will be administered either:

- free of charge if it mimics the national counterpart (the federal government will pay all costs of administration); or
- at the incremental cost of administration, if it is harmonized but somewhat different from its national counterpart (the federal subsidy will only be partial).

For provincial measures that are not harmonized, as defined above, provinces will be charged exactly what it costs Revenue Canada (or the Canada Customs and Revenue Agency) to administer the measures; i.e., the average cost of administration. The federal government will not subsidize the costs of administration of such measures.

All new provincial measures introduced after January 1, 1998 are being administered under the new guidelines. Measures in existence prior to that date will continue to be costed as per the existing agreements, until January 1, 2001, when they will fall under the new guidelines. It will be necessary to renegotiate some existing agreements during this period.

[1] It is assumed that all measures meet the minimum criteria for administration under the tax collection guidelines.

Provincial Measures for Individuals[2]
Administered Under the
Tax Collection Agreements

	Provincial Cost of Administration:		Rationale
	Free of charge	Incremental cost	
1. Newfoundland			
- Basic Provincial Income Tax Rate	√		
- High Income Surtax	√		
- Political Contributions Tax Credit		√	• National definition of recognized political party uses federal parties while provincial definition uses provincial parties.
- Research & Development Tax Credit	√		
- Low Income Senior's Benefit		√	• No equivalent national credit.
- Child Benefit Program	√		
2. Prince Edward Island			
- Basic Provincial Income Tax Rate	√		
- High Income Surtax	√		
- Political Contributions Tax Credit		√	• National definition of recognized political party uses federal parties while provincial definition uses provincial parties.
3. Nova Scotia			
- Basic Provincial Income Tax Rate	√		

[2] Includes all measures announced as at June 30, 1999.

	Provincial Cost of Administration: Free of charge	Provincial Cost of Administration: Incremental cost	Rationale
- High Income Surtax	√		
- Low Income Tax Reduction		√	• No equivalent national program.
- Political Contributions Tax Credit		√	• National definition of recognized political party uses federal parties while provincial definition uses provincial parties.
- Home Ownership Savings Plan Tax Credit		√	• No equivalent national credit.
- Equity Tax Credit		√	• Definition of eligible company differs from national LSVCC credit.
- Labour Sponsored Venture Capital Tax Credit	√		
- Child Benefit Program	√		
4. New Brunswick			
- Basic Provincial Income Tax Rate	√		
- High Income Surtax	√		
- Political Contributions Tax Credit		√	• National definition of recognized political party uses federal parties while provincial definition uses provincial parties.
- Stock Savings Plan Tax Credit		√	• Definition of qualifying company differs from national LSVCC credit. • Provincial design (two-tiered credit) differs from national LSVCC credit.
- Labour Sponsored Venture Capital Fund Tax Credit	√		
- Child Tax Benefit	√[3]		

[3] In terms of administering the Child Tax Benefit, production of separate provincial inserts would be costed on an incremental basis.

	Provincial Cost of Administration:		Rationale
	Free of charge	Incremental cost	
- Working Income Supplement		√	• CCTB defines income in terms of net income while provincial program uses earned income.
- Equity Tax Credit		√	• Definition of eligible company differs from national LSVCC credit.
5. Ontario			
- Basic Provincial Income Tax Rate	√		
- Fair Share Health Care Levy		√	• Provincial design (two-tiered surtax) differs from national surtax.
- Tax Reduction		√	• No equivalent national program.
- Property Tax Credit		√	• No equivalent national credit.
- Sales Tax Credit		√	• No equivalent national credit.
- Political Contributions Tax Credit		√	• National definition of recognized political party uses federal parties while provincial definition uses provincial parties.
- Home Ownership Savings Plan Tax Credit		√	• No equivalent national credit.
- Labour Sponsor Investment Funds Tax Credit	√		
- Employee Ownership Program Tax Credit		√	• No equivalent national credit.
- Mining Reclamation Trust Tax Credit	√		
- Co-operative Education Tax Credit		√	• No equivalent national credit.
- Income Tax Refunds to the Ontario Opportunities Fund		√	• No equivalent national program.
- Graduate Transitions Tax Credit		√	• No equivalent national credit.
- Community Small Business Investment Fund Incentive		√	• No equivalent national program.
- Workplace Child Care Tax Credit		√	• No equivalent national program.
- Workplace Accessibility Tax Credit		√	• No equivalent national program.

	Provincial Cost of Administration:		Rationale
	Free of charge	Incremental cost	
6. Manitoba			
- Basic Provincial Income Tax Rate	√		
- High Income Surtax		√	• Provincial design (surtax on net income) differs from national surtax.
- Flat Tax (on net income)		√	• No equivalent national program.
- Tax Reduction		√	• No equivalent national program.
- Surtax Reduction		√	• No equivalent national program.
- Property Tax Credit		√	• No equivalent national credit.
- Cost of Living Tax Credit		√	• No equivalent national credit.
- Political Contributions Tax Credit		√	• National definition of recognized political party uses federal parties while provincial definition uses provincial parties.
- Royalty Tax Rebate		√	• No equivalent national program.
- Labour Sponsored Funds Tax Credit	√		
- Homeowner's School Tax Assistance		√	• No equivalent national program.
- Learning Tax Credit	√		
- Equity Tax Credit		√	• Definition of eligible company differs from national LSVCC credit.
7. Saskatchewan			
- Basic Provincial Income Tax Rate	√		
- Flat Tax (on net income)		√	• No equivalent national program.
- High Income Surtax		√	• Provincial design (two-tiered surtax) differs from national surtax.
- Debt Reduction Surtax		√	• No equivalent national program.

	Provincial Cost of Administration:		Rationale
	Free of charge	Incremental cost	
- Low Income Tax Reduction		√	• No equivalent national program.
- Debt Reduction Surtax Reduction		√	• No equivalent national program.
- Royalty Tax Rebate		√	• No equivalent national program.
- Labour Sponsored Venture Capital Tax Credit	√		
- Child Benefit Program	√[4]		
8. Alberta			
- Basic Provincial Income Tax Rate	√		
- High Income Surtax	√		
- Flat Tax (on taxable income)		√	• No equivalent national program.
- Selective Tax Reduction		√	• No equivalent national program.
- Royalty Tax Credit / Rebate		√	• No equivalent national program.
- Political Contributions Tax Credit		√	• National definition of recognized political party uses federal parties while provincial definition uses provincial parties.
- Family Employment Tax Credit		√[5]	• CCTB defines income in terms of net income while provincial program uses employment income.
9. British Columbia			
- Basic Provincial Income Tax Rate	√		

[4] In terms of administering the Child Benefit Program, any customized reporting requests specific to the provincial program and provincial consent forms would be costed on an incremental basis.

[5] In terms of administering the Family Employment Tax Credit, costs associated with non-matching payment dates and frequency and special messaging (telecom) services would also be costed on an incremental basis.

	Provincial Cost of Administration:		Rationale
	Free of charge	Incremental cost	
- High Income Surtax		√	• Provincial design (two-tiered surtax) differs from national surtax.
- Surtax Reduction		√	• No equivalent national program.
- Royalty and Deemed Income Rebate		√	• No equivalent national program.
- Political Contributions Tax Credit		√	• National definition of recognized political party uses federal parties while provincial definition uses provincial parties.
- Logging Tax Credit	√		
- Small Business Venture Capital Tax Credit		√	• Definition of eligible business differs from national LSVCC credit.
- Employee Share Ownership Plan Tax Credit		√	• No equivalent national credit.
- Employee Venture Capital Plan Tax Credit	√		
- Refundable Sales Tax Credit		√	• No equivalent national credit.
- Family Bonus – Basic Benefit	√[6]		
- Family Bonus – Earned Income Supplement		√	• CCTB defines income in terms of net income while provincial program uses earned income.
- Mining Exploration Tax Credit		√	• No equivalent national credit.
10. Nunavut Territory			
- Basic Provincial Income Tax Rate	√		
- Political Contributions Tax Credit		√	• National definition of recognized political party uses federal parties while territorial definition uses territorial candidates.
- Cost of Living Tax Credit		√	• No equivalent national credit.

[6] In terms of administering the Family Bonus, administration of different residency rules would be costed on an incremental basis.

	Provincial Cost of Administration:		Rationale
	Free of charge	Incremental cost	
- Labour Sponsored Venture Capital Corporation Tax Credit	√		
- Employee Venture Capital Corporation Tax Credit		√	• Definition of eligible investment differs from national LSVCC credit.
- Community Endorsed Venture Capital Corporation Tax Credit		√	• Definition of eligible investment differs from national LSVCC credit.
- Child Benefit – Basic Benefit	√		
- Child Benefit – Workers' Supplement		√	• CCTB defines income in terms of net income while provincial program uses earned income.
11. Northwest Territories			
- Basic Provincial Income Tax Rate	√		
- Political Contributions Tax Credit		√	• National definition of recognized political party uses federal parties while territorial definition uses territorial candidates.
- Cost of Living Tax Credit		√	• No equivalent national credit.
- Labour Sponsored Venture Capital Corporation Tax Credit	√		
- Employee Venture Capital Corporation Tax Credit		√	• Definition of eligible investment differs from national LSVCC credit.
- Community Endorsed Venture Capital Corporation Tax Credit		√	• Definition of eligible investment differs from national LSVCC credit.
- Child Benefit – Basic Benefit	√		
- Child Benefit – Workers' Supplement		√	• CCTB defines income in terms of net income while provincial program uses earned income.

	Provincial Cost of Administration:		Rationale
	Free of charge	Incremental cost	
12. Yukon Territory			
- Basic Provincial Income Tax Rate	√		
- High Income Surtax	√		
- Low Income Family Tax Credit		√	• No equivalent national credit.
- Political Contributions Tax Credit		√	• National definition of recognized political party uses federal parties while territorial definition uses territorial parties.
- Mineral Exploration Tax Credit		√	• No equivalent national credit.
- Small Business Investment Tax Credit		√	• Definition of eligible investment differs from national LSVCC credit.
- Child Benefit Program	√		
- Labour Sponsored Venture Capital Tax Credit	√		

Provincial Measures for Corporations[7]
Administered Under the
Tax Collection Agreements

	Provincial Cost of Administration:		Rationale
	Free of charge	Incremental cost	
1. Newfoundland			
- General Corporate Income Tax Rate	√		
- Small Business Corporate Income Tax Rate	√		
- M&P Profits Tax Credit (M&P Tax Rate)	√		
- Political Contributions Tax Credit		√	• National definition of recognized political party uses federal parties while provincial definition uses provincial parties.
- Research & Development Tax Credit	√		
- Film and Video Industry Tax Credit		√	• Definition of eligible corporation differs from national Film or Video Production credit.
2. Prince Edward Island			
- General Corporate Income Tax Rate	√		
- Small Business Corporate Income Tax Rate	√		
- M&P Profits Tax Credit (M&P Tax Rate)	√		
- Political Contributions Tax Credit		√	• National definition of recognized political party uses federal parties while provincial definition uses provincial parties.
- M&P Investment Tax Credit		√	• Definition of qualified property differs from Atlantic Canada ITC program.

[7] Includes all measures announced as at June 30, 1999.

	Provincial Cost of Administration: Free of charge	Incremental cost	Rationale
3. Nova Scotia			
- General Corporate Income Tax Rate	√		
- Small Business Corporate Income Tax Rate	√		
- Political Contributions Tax Credit		√	• National definition of recognized political party uses federal parties while provincial definition uses provincial parties.
- Research & Development Tax Credit	√		
- New Small Business Tax Holiday		√	• No equivalent national program.
- ISO9000 Certification Tax Credit		√	• No equivalent national credit.
- Prospectus Costs Tax Credit		√	• No equivalent national credit.
- Film Tax Credit		√	• Definition of eligible corporation differs from national Film or Video Production credit.
- ISO14000 Certification Tax Credit		√	• No equivalent national credit.
- M&P Investment Tax Credit		√	• Definition of qualified property differs from Atlantic Canada ITC program.
- Corporate Capital Tax	√		
4. New Brunswick			
- General Corporate Income Tax Rate	√		
- Small Business Corporate Income Tax Rate	√		
- Political Contributions Tax Credit		√	• National definition of recognized political party uses federal parties while provincial definition uses provincial parties.
- Research & Development Tax Credit	√		

	Provincial Cost of Administration:		Rationale
	Free of charge	Incremental cost	
- Labour Incentive Film Tax Credit		√	• Definition of eligible corporation differs from national Film or Video Production credit.
- Corporate Capital Tax	√		
5. Manitoba			
- General Corporate Income Tax Rate	√		
- Small Business Corporate Income Tax Rate	√		
- Political Contributions Tax Credit		√	• National definition of recognized political party uses federal parties while provincial definition uses provincial parties.
- Scientific Research Investment Tax Credit	√		
- M&P Investment Tax Credit		√	• No equivalent national program.
- Film and Video Production Tax Credit		√	• Definition of eligible corporation differs from national Film or Video Production credit.
6. Saskatchewan			
- General Corporate Income Tax Rate	√		
- Small Business Corporate Income Tax Rate	√		
- M&P Profits Tax Credit (M&P Tax Rate)		√	• Design of rate calculation (phase-out of reduction) differs from national.
- Royalty Tax Rebate		√	• No equivalent national program.
- M&P Investment Tax Credit		√	• No equivalent national program.
- Mine Reclamation Trust Tax Credit	√		

	Provincial Cost of Administration:		Rationale
	Free of charge	Incremental cost	
- Film Employment Tax Credit		√	• Definition of eligible corporation differs from national Film or Video Production credit. • Provincial design (two-tiered credit) differs from national Film or Video Production credit.
- Research & Development Tax Credit	√		
7. British Columbia			
- General Corporate Income Tax Rate	√		
- Small Business Corporate Income Tax Rate	√		
- Royalty and Deemed Income Rebate		√	• No equivalent national program.
- Political Contributions Tax Credit		√	• National definition of recognized political party uses federal parties while provincial definition uses provincial parties.
- Logging Tax Credit	√		
- Small Business Venture Capital Tax Credit		√	• Definition of eligible business differs from national LSVCC credit.
- Mine Reclamation Trust Tax Credit	√		
- New Small Business Tax Holiday		√	• No equivalent national program.
- Film and Television Tax Credit		√	• Definition of eligible corporation differs from national Film or Video Production credit. • Provincial design (three-tiered credit) differs from national Film or Video Production credit.
- Production Services Tax Credit	√		
- Mining Exploration Tax Credit		√	• No equivalent national credit.

	Provincial Cost of Administration:		Rationale
	Free of charge	Incremental cost	
8. Nunavut Territory			
- General Corporate Income Tax Rate	√		
- Small Business Corporate Income Tax Rate	√		
- Political Contributions Tax Credit		√	• National definition of recognized political party uses federal parties while territorial definition uses territorial candidates.
- Labour Sponsored Venture Capital Corporation Tax Credit	√		
- Employee Venture Capital Corporation Tax Credit		√	• Definition of eligible investment differs from national LSVCC credit.
- Community Endorsed Venture Capital Corporation Tax Credit		√	• Definition of eligible investment differs from national LSVCC credit.
9. Northwest Territories			
- General Corporate Income Tax Rate	√		
- Small Business Corporate Income Tax Rate	√		
- Political Contributions Tax Credit		√	• National definition of recognized political party uses federal parties while territorial definition uses territorial candidates.
- Labour Sponsored Venture Capital Corporation Tax Credit	√		
- Employee Venture Capital Corporation Tax Credit		√	• Definition of eligible investment differs from national LSVCC credit.
- Community Endorsed Venture Capital Corporation Tax Credit		√	• Definition of eligible investment differs from national LSVCC credit.

	Provincial Cost of Administration:		Rationale
	Free of charge	Incremental cost	
10. Yukon Territory			
- General Corporate Income Tax Rate	√		
- Small Business Corporate Income Tax Rate	√		
- M&P Profits Tax Credit (M&P Tax Rate)	√		
- Political Contributions Tax Credit		√	• National definition of recognized political party uses federal parties while territorial definition uses territorial parties.
- Mineral Exploration Tax Credit		√	• No equivalent national credit.

Provincial Measures Administered Under
Sales Tax Collection Agreements (CITCAs)

	Provincial Cost of Administration:		Rationale
	Free of charge	Incremental cost	
1. Newfoundland			
- Harmonized Sales Tax Collection	√		
- Harmonized Sales Tax Credit	√		
2. Nova Scotia			
- Harmonized Sales Tax Collection	√		
3. New Brunswick			
- Harmonized Sales Tax Collection	√		

Provincial Measures Administered Under Administrative Agreements

The following provincial measures are covered under administrative agreements between the provinces and Revenue Canada. As such, these measures should be administered on a full cost recovery basis (i.e., average cost).

1. **Newfoundland**

   - Collection of liquor fees in the traveller stream at the border

2. **Prince Edward Island**

   - Collection of liquor fees in the traveller stream at the border

3. **Nova Scotia**

   - Collection of liquor fees in the traveller stream at the border

4. **New Brunswick**

   - Collection of liquor mark-ups in the traveller and courier streams at the border
   - Collection of tobacco taxes in the traveller, postal and courier streams at the border

5. **Québec**

   - Collection of sales tax on non-commercial importations in the traveller, postal and courier streams at the border
   - Collection of taxes on alcoholic beverages in the traveller and courier streams at the border
   - Collection of tobacco taxes on non-commercial importations in the traveller, postal and courier streams at the border
   - Collection of liquor mark-ups in the traveller stream at the border
   - Visitors Rebate Program (sales tax)

6. Ontario

- Collection of liquor mark-ups in the traveller stream at the border
- Collection of sales tax on non-commercial importations in the traveller, postal and courier streams at the border
- Collection of tobacco taxes in the traveller stream at the border
- Collection of gasoline and fuel taxes at the border

7. Manitoba

- Collection of sales tax on non-commercial importations in the traveller, postal and courier streams at the border
- Collection of liquor mark-ups in the traveller and courier streams at the border
- Collection of tobacco taxes in the traveller and courier streams at the border
- Visitors Rebate Program (sales tax)

8. Saskatchewan

- Collection of liquor mark-ups in the traveller stream at the border
- Collection of tobacco taxes in the traveller stream at the border

9. Alberta

- Collection of liquor fees in the traveller stream at the border

10. British Columbia

- Collection of liquor mark-ups in the traveller stream at the border
- Collection of tobacco taxes in the traveller stream at the border

11. Yukon

- Collection of liquor fees in the traveller stream at the border

Annex 6

AN ANALYSIS OF PERSONAL INCOME TAX FLOWS TO PROVINCES UNDER THE INCOME TAX COLLECTION AGREEMENTS (1995, 1996, 1997)

September 1999

INTRODUCTION

The federal government has Tax Collection Agreements with all provinces except Quebec to collect personal income tax on their behalf and to pay them on the basis of taxes assessed. Under the terms of these agreements, the federal government absorbs all bad debts and administrative costs and retains any interest and penalties collected from late taxpayers.

In the wake of the acceleration of tax collections introduced over the last several years, a question was raised at the beginning of 1997 by some provinces as to whether the income tax revenues collected by the federal government on behalf of all the provinces participating in the TCAs were in fact still being transferred to the provinces quickly enough. To answer this question a consultant was engaged to undertake a detailed assessment of the timing of payments relative to collections[1]. A spreadsheet model of tax collections and assessments and the tax payments to provinces was constructed using daily data provided by Revenue Canada for the 1995 taxation year (the last year for which data on all the components of the analysis were available). Using this model, the present value of the provincial personal income tax (PIT) collections and assessments was compared to the present value of the tax payments to provinces.

If there is a substantial delay in the transfer of funds to provinces, the federal government retains these funds for its own use for a period of time and thus keeps the interest earned on the funds. On the other hand, if cash flows to provinces are in advance of collections of the tax assessed, the provinces benefit from the interest earned on the transferred funds. The present value of the difference between provincial tax collected and assessed and the tax payments made to the provinces provides a measure of the extent to which the flows are not of equivalent value.

The central conclusion of the Grady study was that the net present value of the difference between the streams of PIT collections based on assessments and payments to provinces favoured the federal government to the tune of $99 million in 1995, implying late payments to provinces. Based on the analysis, and on the belief that 1995 was representative of the situation going forward, two steps were taken:

1. As the study of payments was initiated in 1997, a payment of $99 million (plus interest) in respect of that year was provided to the provinces by the federal government.

2. Effective with the 1998 taxation year and going forward, the schedule of payments under the TCAs was adjusted forward by two payments.

   A total of forty-eight payments, four per month, are made to the provinces in respect of a taxation year. Payments are made on the:

   - 6th working day of the month;
   - 3rd working day following the 15th;

[1] *An Analysis of Personal Income Tax Flows to Provinces Under the Income Tax Collection Agreements*, December 1997, Patrick Grady, Global Economics.

- 1st working day following the 20th;
- 2nd last working day of the month.

Prior to the payment schedule being adjusted forward by two payments, the first payment in respect of a taxation year was made on the 3rd working day following the 15th of February. Starting in 1998, the first payment is provided on the 2nd last working day of January. Using 1995 as an example, the first payment to the provinces was made on February 20, 1995. Had the adjusted schedule been in effect, the first payment would have been provided January 30, 21 days earlier.

ISSUE

An important assumption made in providing a one-time payment to the provinces in respect of the 1997 taxation year and in adjusting the schedule of payments forward by two weeks was that the 1995 taxation year (which formed the basis of the study) was representative of the situation going forward. To verify the validity of this assumption, the federal government agreed to repeat the exercise internally on the basis of the 1996 and 1997 tax years using the Grady framework.

The results of the initial Grady study on the basis of the 1995 taxation year, and of the current study on the basis of the 1996 and 1997 taxation years, the two most recent years for which data are available, were provided to the provinces in June 1999. However, the methodology used in the initial Grady study was modified slightly and the exercise was re-done, following concerns raised by some provinces about the magnitude of the accounts receivables presented in the study.

The following summary, and the attached Appendix provide greater detail regarding the data sources used in the analysis, and a summary of the estimated monthly provincial taxes collected and cash flows to provinces for the taxation years examined under the modified methodology.

SUMMARY OF REVISED ANALYSIS

The methodology used was identical to that used by Grady. Three major steps were carried out:

1. A daily time series of net provincial tax collected was constructed. As the daily collections information was not available for all the components of collections and was not identified with respect to taxation year, it was necessary to construct an estimate based on a number of assumptions. It was also necessary to estimate the collections of provincial tax since, at the time tax payments are received, there is no indication of the split between the federal and provincial components.

2. A time series of cash payments to the provinces was constructed. As the payments are equal and the payment dates are set out in the Agreements (the payment schedule used was that which was in effect prior to 1998), it was a trivial exercise to line up the payments with the due dates. In establishing this time series of payments which was necessary to properly assess the adequacy of the cash flow to provinces, it was assumed that the value of provincial tax assessed was accurately forecast at the beginning of the period before the cash flows to

the provinces began (year-end adjustments are made to compensate for such inaccuracies). This eliminated forecasting errors as a factor influencing cash flow and focussed the analysis on the differences in timing of the collections and payments stream.

3. The collections and payments were then compared by taking the present value of the differences in the two series at the beginning of the taxation years. The assumption is that, if offered a choice, provincial governments, fully appreciating the importance of the time value of money, would prefer the cash flow stream with the greater present value.

RESULTS OF REVISED ANALYSIS

The results of the revised study for the 1995, 1996, and 1997 taxation years are shown in Table 1 below.

Table 1

Year	Discount Rate T-Bill Rate (%)	Present Value of Difference Between Net Provincial Tax Collected and Payments to Provinces* ($millions)	Approximate Forward Adjustment Required for a Neutral Payment System
1995	6.98	81.6	15 days
1996	4.31	59.4	16 days
1997	3.21	22.3	8 days

*Payments schedule used was that which was in effect prior to 1998 taxation year.

As mentioned earlier, on the basis of the revised results for the 1995 taxation year, a payment in the amount of $99 million (plus interest) in respect of the 1997 taxation year was provided to the provinces in 1998. With modifications to the Grady model to take into account arrears, the $99 million figure is now $81.6 million. The revised analysis of 1996 and 1997 revealed that the net present value of the difference between the time streams of personal income tax collections based on assessments and payments to provinces benefited the federal government by $59.4 million for 1996, and by $22.3 million for 1997.

The second and probably more important issue at this time is whether the new schedule for payments to the provinces, in effect since 1998, benefits one level of government over the other. Effective with the 1998 taxation year, the schedule of payments under the TCAs was adjusted forward by two payments (i.e. payments are made about 13 days earlier on average). The analysis shows that for 1995, 1996, and 1997, adjustments of about 15, 16, and 8 days respectively (three year average of about 15 days) would have been required to achieve a neutral payment system. On this basis it would appear that on average the new schedule of payments to the provinces achieves the objective of a neutral payments system. Chart 1 provides a graphic illustration for the 1997 taxation year of provincial tax collected versus payments to provinces using the new schedule of payments.

The results are sensitive to the taxation year being examined. The following is a list and brief explanation of some of the factors that may affect the results.

Factors Affecting Value of Benefit

Discount Rate. In years where the payments system is not neutral, the discount rate has a direct effect on how much money is involved. For example, in 1997 the average government of Canada three-month T-Bill rate was 3.21%. Each 1% variation in the rate would lead to an increase or decrease of about $7.1 million in the present value of the difference between the net provincial tax collected and the payments to provinces.

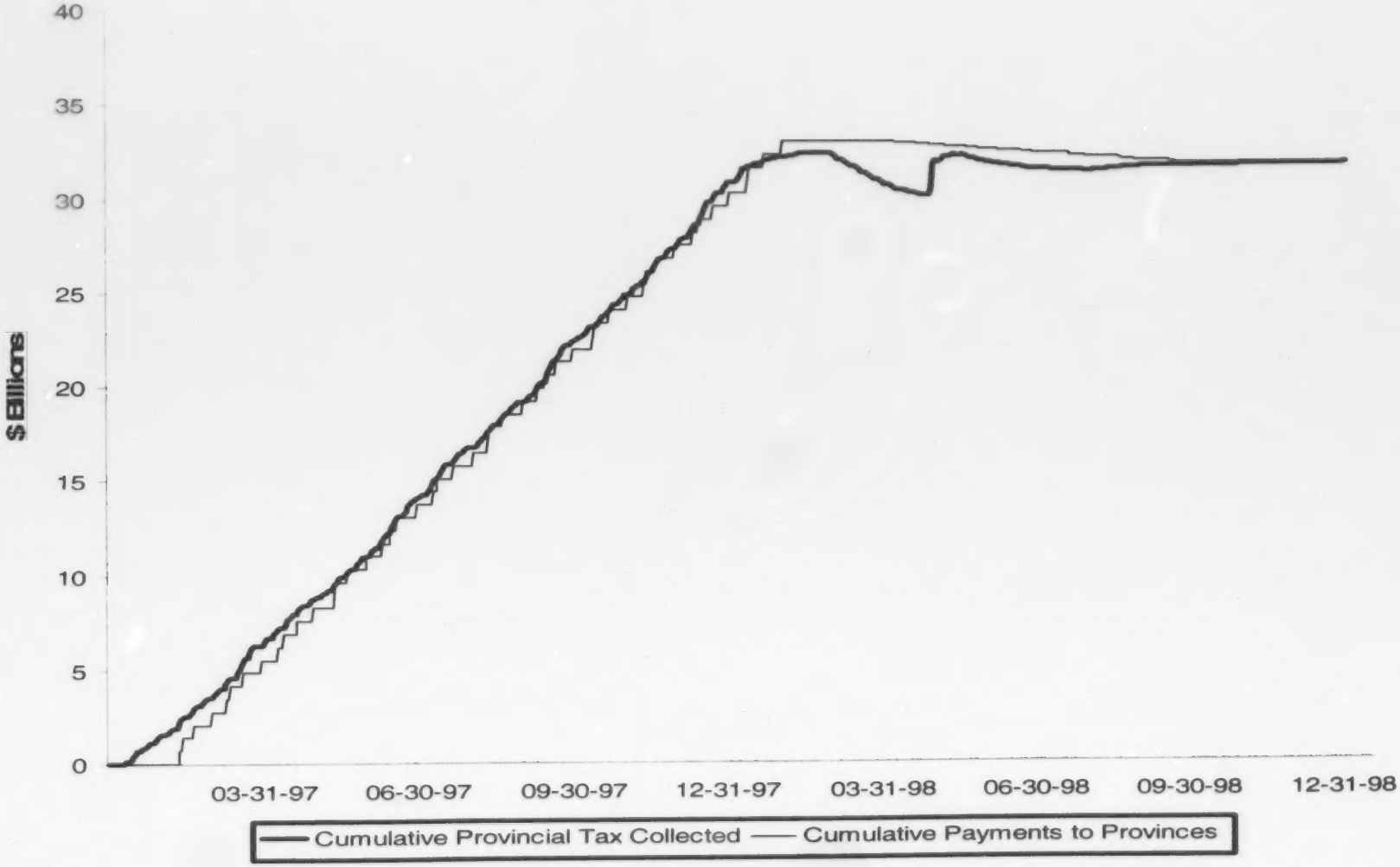
Factors Affecting Adequacy of Timing of Payments to Provinces

Timing of collections. The timing of collections differs from year to year and this has an effect on the results. If one examines source deduction remittances (which account for 85% to 90% of taxes collected) for 1996 versus those for 1997, the cumulative source deduction remittances for 1996 were consistently ahead of the 1997 remittances until the 10th of February, and ahead about half of the time from the 11th of February until mid-April. This is the case despite the fact that total source deductions for 1996 were $90.3 billion versus $94.7 billion for 1997.

"Timing" of the timing of payments. The "timing" of the timing of payments itself can affect the results. If one compares the payments schedule for the 1996 tax year to that of the 1997 tax year, payments were made a cumulative 51 days earlier for 1997 than for 1996. While the same formula was used to determine the payments schedule for both years, the end result differs because of when weekends and statutory holidays fall in each year.

Mix of source of income taxes. The mix of the source of income taxes collected affects the results. For example, 10% of net collections in 1995 were in the form of instalment payments, compared to 11% for 1997. Where a greater percentage of taxes collected comes from sources that begin to be collected later in the taxation year (such as instalment payments and payments on filing), the provinces are favoured. Where a greater percentage of taxes collected comes from sources that begin to be collected earlier in the taxation year (such as source deductions), the federal government is favoured. This would suggest a cyclical influence in the receipt of payments.

1997 Taxation Year
Provincial Tax Collected versus Payments to Provinces
(accelerated payments schedule)



APPENDIX

THE APPROACH

The basic approach to constructing the daily data in the spreadsheet used in the analysis is described below. The monthly data are shown in Tables 1, 2, and 3 for 1995, 1996, and 1997 respectively. A thorough understanding of how the data are organized is necessary to carry out analysis using the spreadsheet. Table 4 shows the annual collections data that provided the benchmarks for the daily data. Table 5 provides the data on tax assessed and the provincial share from the *Final Determination of Payments under the Tax Collection Agreements*.

This analysis has not taken into account the cost to the federal government of administering the provincial tax account on behalf of provinces. Administrative costs, except for those occasioned by the tax credits and rebates, are totally absorbed by the federal government.

Net Provincial Tax Collected

Income taxes are collected in a number of ways. Table 4 provides the annual breakdown of the ways that total net federal and provincial tax is collected.

The following provides documentation for the columns in the spreadsheet used to calculate the present value of the difference between provincial tax collections and payments (see Tables 1, 2, and 3). Additional columns necessary to calculate the data for the eleven columns described below are contained in the spreadsheet.

Deductions at Source (Column 1). This is the major vehicle for collecting personal income tax. Data on daily deductions at source are available from Revenue Canada's PAYDAC. Deductions at source and transfers to Revenue Canada in respect of the Canada Pension Plan and Employment Insurance contributions are also made and these must be deducted in order to arrive at deductions in respect of income tax for the given year. The monthly contributions for CPP and EI are divided equally among the business days of the month and subtracted from the PAYDAC daily source deductions to estimate daily income tax receipts. It is also necessary to make adjustments for the timing of deductions at source. In January and even early February some of the deductions are for the prior tax year.

Remitters are divided into regular remitters and two groups of accelerated remitters. Regular remitters are required to remit on or before the 15th of the following month. Accelerated remitters paying over $15,000 per month are required to remit twice a month on or before the 25th of the month and the 10th of the following month. Accelerated remitters paying over $50,000 per month are required to remit on or before the 10th, 17th, and 24th of the month and 3rd of the following month. According to data provided by Revenue Canada, 17.75 per cent of the remittances are made by regular remitters, 9.3 per cent by the first group of accelerated remitters and 72.95 per cent by the second group. It is thus assumed that 100 per cent of the source deductions made up to January 10th are for the prior taxation year, 27.05 per cent of the source deductions made between January 11th and January 24th are for the prior taxation year, and 17.75 per cent of the deductions between January 25th and February 14th are for the prior taxation year.

The estimated daily source deductions for income tax are scaled to equal the annual figures shown in Table 4 provided by Revenue Canada.

Instalment Payments (Column 2). These are made by the self-employed or by those with substantial investment income. These payments are included as received over the period from April in a given year to March of the following year. Monthly instalment payments data provided by Revenue Canada are distributed in the months of March, June, September, and December using the CINDAC daily data provided by Revenue Canada. In these months the largest portion of the CINDAC receipts stems from instalment payments. In other months, the monthly payments are distributed equally across business days.

Payments on Filing and Arrears (Column 3). Income tax payments are also made upon or after the filing of tax returns after the end of the tax year. Payments in respect of a given taxation year made upon filing are included as receipts during the period January to December of the following year, with the bulk of the payments falling in April and May. The monthly collections provided by Revenue Canada were distributed across the days of the month in April and May using the CINDAC distribution since in these months most of those collections were for payments upon filing. In other months, payments on filing were prorated across all of the business days in the month. Payments made after the filing of tax returns (for example, where post-dated cheques are enclosed with tax returns or where taxpayers make payments after the reassessment of tax returns) are included as receipts during the period of January to December of the following year. The monthly collections provided by Revenue Canada were prorated across all of the business days of the month.

Receivables (Column 4). Taxes assessed but not paid in respect of a given taxation year can be established as accounts receivable in May of the following year. For this exercise, accounts receivable were estimated as the difference between total tax assessed and the sum of deductions at source, instalment payments, and payments on filing minus refunds for overpayment of tax all taken from Table 4. Some receivables turn out to be bad debts and are not collectible. The receivables used in the analysis have not been reduced by the amount of the bad debts as these debts are absorbed by the federal government under the terms of the TCAs.

Refunds (Column 5). Refunds of tax collected are made to those whose tax assessed is less than the deductions at source or instalment payments they have made. Refunds due to overpayment of tax in respect of a given taxation year are assumed to extend from January to December of the following year. The monthly data on refunds provided by Revenue Canada exclude refunds arising out of items other than overpayment of tax (i.e. federal refundable credits, refundable provincial credits, employment insurance and CPP overpayments) so it is not necessary to adjust the series as was done in past studies. The monthly data are prorated daily across business days of the month.

Net Collections (Column 6). The time stream of total net collections of federal and personal income tax is equal to the sum, day by day, of the deductions at source, instalment payments, payments on filing and receivables less refunds.

Provincial Share (Column 7). The ratio of provincial tax assessed to total federal and provincial tax assessed for each taxation year is calculated in the spreadsheet and is shown in Table 5. The annual ratio is applied to net collections for each day to determine the provincial share of net collections for each day.

Provincial Credits and Rebates (Column 8). Provincial credits and rebates have been deducted over the period from January to December of the following taxation year. The monthly data provided by Revenue Canada are prorated daily across the business days of the month and the total is scaled to equal the total from the Final TCA settlement book.

Net Provincial Tax Collected and Assessed (Column 9). Credits and rebates are deducted from the provincial share of tax collections to determine net provincial tax collections.

Tax Payments to Provinces

To assess the functioning of the system of payments to provinces, it is necessary to make a valid comparison between the time stream of net provincial tax collected and the time stream of the cash flows to provinces. This requires the assumption be made that the value of provincial tax assessed has been accurately forecast when the monthly cash flows to provinces began.
Under the terms of the TCAs the amount payable to provinces and the amount the federal government is obliged to forecast for payments purposes is the income tax assessed under the provincial income tax acts plus the provincial share of taxes that are collected but that do not result in assessments because the returns are not filed by the taxpayer. It is assumed that such unapplied tax collections are also accurately forecast. The unapplied taxes are built into the provincial tax estimated at the beginning of each period.

Under the terms of the TCAs the federal government makes payments to provinces based on provincial tax "assessed". Taxes assessed will exceed taxes collected by the value of bad debts which the federal government absorbs.

Tax Payments (Cash Flow) to Provinces (Column 10). Instalment payments to provinces in respect of a given taxation year are made in 48 equal payments over the period from February of the tax year to February of the following year. The payments are made on the 6th business day of each month, the 3rd business day after the 15th of the month, the first business day following the 20th, and the second to last business day of the month. Deductions in respect of provincial credits and rebates in respect of a given taxation year are made during the period from April to September of the following taxation year in 24 equal amounts on the same days the regular payments are scheduled. This roughly corresponds to the period over which the provincial credits and rebates are assessed and paid to taxpayers.

Comparison of Net Provincial Tax Collected and Assessed and Tax Payments to Provinces

Surplus or Deficit (Column 11). A time stream of the differences between net provincial tax collected and assessed and the tax payments to provinces is determined.

Interest Rate. By applying an appropriate interest rate to the difference between collections and payments, it is possible to determine the present value of the difference between the two time series. The present value is a measure of the extent to which there is a lack of coincidence between net provincial tax collections by the federal government and cash flow to provinces. The present values of the differences between the two time series were calculated using the annual average of the Government of Canada three-month treasury bill rate for the taxation year as the discount rate. This is appropriate as the treasury bill rate represents the cost of short-term funds to the federal government. Such short-term borrowings are the usual source of funds for cash management.

PENDIX TABLE 1

COMPARISON OF NET PROVINCIAL INCOME TAX COLLECTED AND CASH FLOWS TO PROVINCES UNDER INCOME TAX AGREEMENT – MONTHLY SUMMARY FOR 1995 TAXATION YEAR

($ millions)

nth	Year	(1) Deductions at Source	(2) Instalment Payments	(3) Arrears & Payments on Filing	(4) Receivables	(5) Refunds	(6) Net Collections	(7) Provincial Share 31.86%	(8) Provincial Credits & Rebates	(9) Net Provincial Tax Collected	(10) Cash Flow to Provinces	(11) Surplus + Deficit -
.	95	5,505	0	0	0	0	5,505	1,754	0	1,754	0	1,754
.	95	4,925	0	0	0	0	4,925	1,569	0	1,569	1,912	(343)
rch	95	7,644	1,815	0	0	0	9,459	3,014	0	3,014	2,549	465
il	95	6,245	147	0	0	0	6,392	2,037	0	2,037	2,549	(513)
y	95	7,287	201	0	0	0	7,488	2,386	0	2,386	2,549	(164)
e	95	6,905	1,744	0	0	0	8,649	2,756	0	2,756	2,549	206
y	95	7,928	169	0	0	0	8,097	2,580	0	2,580	2,549	31
.	95	6,903	91	0	0	0	6,994	2,228	0	2,228	2,549	(321)
t.	95	6,736	2,397	0	0	0	9,133	2,910	0	2,910	2,549	361
.	95	7,352	197	0	0	0	7,549	2,405	0	2,405	2,549	(144)
.	95	7,434	108	0	0	0	7,542	2,403	0	2,403	2,549	(146)
.	95	6,228	2,001	0	0	0	8,229	2,622	0	2,622	2,549	72
al	**95**	81,092	8,870	0	0	0	89,962	28,665	0	28,665	27,046	1,258
.	96	5,305	549	109	0	(119)	5,844	1,862	(3)	1,859	2,549	(690)
.	96	0	191	144	0	(257)	78	25	(4)	21	637	(617)
rch	96	0	0	518	0	(4,085)	(3,567)	(1,137)	(391)	(1,527)	0	(1,527)
il	96	0	0	2,474	0	(3,092)	(618)	(197)	(427)	(624)	(226)	(398)
y	96	0	0	5,698	1,947	(3,602)	4,043	1,288	(354)	934	(226)	1,160
e	96	0	0	741	0	(1,362)	(621)	(198)	(85)	(282)	(226)	(57)
y	96	0	0	449	0	(489)	(40)	(13)	(33)	(46)	(226)	180
.	96	0	0	568	0	(272)	296	94	(25)	69	(226)	295
t.	96	0	0	301	0	(265)	36	11	(13)	(1)	(226)	225
.	96	0	0	408	0	(145)	263	84	(9)	74	0	74
.	96	0	0	333	0	(116)	217	69	(6)	63	0	63
.	96	0	0	221	0	(100)	121	39	(5)	33	0	33
tal	**96**	5,305	740	11,964	1,947	(13,904)	6,052	1,928	(1,356)	573	1,831	(1,258)
AND	**TOTAL**	86,397	9,610	11,964	1,947	(13,904)	96,014	30,593	(1,356)	29,237	29,237	0

Government of Canada 3-month T-Bill Rate 6.98%

Net Present Value of Surplus/Deficit (Beginning of 1995) 81.6

PENDIX TABLE 2

COMPARISON OF NET PROVINCIAL INCOME TAX COLLECTED AND CASH FLOWS TO PROVINCES UNDER INCOME TAX AGREEMENT – MONTHLY SUMMARY FOR 1996 TAXATION YEAR
($ millions)

nth	Year	(1) Deductions at Source	(2) Instalment Payments	(3) Arrears & Payments on Filing	(4) Receivables	(5) Refunds	(6) Net Collections	(7) Provincial Share 31.56%	(8) Provincial Credits & Rebates	(9) Net Provincial Tax Collected	(10) Cash Flow to Provinces	(11) Surplus + Deficit -
	96	5,291	0	0	0	0	5,291	1,670	0	1,670	0	1,670
.	96	6,216	0	0	0	0	6,216	1,962	0	1,962	1,990	(28)
ch	96	7,710	1,894	0	0	0	9,604	3,031	0	3,031	2,653	378
l	96	6,886	135	0	0	0	7,021	2,216	0	2,216	2,653	(437)
y	96	6,933	212	0	0	0	7,145	2,255	0	2,255	2,653	(398)
e	96	7,411	1,882	0	0	0	9,293	2,933	0	2,933	2,653	280
	96	8,603	171	0	0	0	8,774	2,769	0	2,769	2,653	116
.	96	6,873	139	0	0	0	7,012	2,213	0	2,213	2,653	(440)
t.	96	7,447	2,950	0	0	0	10,397	3,281	0	3,281	2,653	628
	96	7,457	168	0	0	0	7,625	2,407	0	2,407	2,653	(247)
.	96	7,894	146	0	0	0	8,040	2,538	0	2,538	2,653	(116)
.	96	6,518	2,796	0	0	0	9,314	2,940	0	2,940	2,653	286
al	**96**	85,240	10,493	0	0	0	95,733	30,216	0	30,216	28,525	1,691
.	97	4,378	292	442	0	(97)	5,015	1,583	(0)	1,583	2,653	(1,071)
.	97	660	77	360	0	(254)	843	266	(65)	202	663	(462)
ch	97	0	0	547	0	(4,698)	(4,151)	(1,310)	(327)	(1,637)	0	(1,637)
l	97	0	0	2,730	0	(3,099)	(369)	(116)	(394)	(510)	(208)	(302)
y	97	0	0	6,128	883	(3,668)	3,343	1,055	(300)	756	(208)	964
e	97	0	0	898	0	(1,277)	(379)	(120)	(81)	(201)	(208)	7
	97	0	0	544	0	(591)	(47)	(15)	(22)	(37)	(208)	171
.	97	0	0	462	0	(329)	133	42	(20)	22	(208)	230
t.	97	0	0	471	0	(256)	215	68	(22)	46	(208)	254
	97	0	0	351	0	(152)	199	63	(9)	53	0	53
.	97	0	0	267	0	(127)	140	44	(4)	40	0	40
.	97	0	0	304	0	(95)	209	66	(4)	62	0	62
al	**97**	5,039	369	13,504	883	(14,643)	5,152	1,626	(1,249)	377	2,068	(1,691)
AND	**TOTAL**	90,278	10,862	13,504	883	(14,643)	100,884	31,842	(1,249)	30,593	30,593	0

Government of Canada 3-month T-Bill Rate 4.31%
Net Present Value of Surplus/Deficit (Beginning of 1996) 59.4

ENDIX TABLE 3

COMPARISON OF NET PROVINCIAL INCOME TAX COLLECTED AND CASH FLOWS TO PROVINCES UNDER INCOME TAX AGREEMENT – MONTHLY SUMMARY FOR 1997 TAXATION YEAR

($ millions)

th	Year	(1) Deductions at Source	(2) Instalment Payments	(3) Arrears & Payments on Filing	(4) Receivables	(5) Refunds	(6) Net Collections	(7) Provincial Share 30.33%	(8) Provincial Credits & Rebates	(9) Net Provincial Tax Collected	(10) Cash Flow to Provinces	(11) Surplus + Deficit -
	97	5,164	0	0	0	0	5,164	1,566	0	1,566	0	1,566
	97	6,451	0	0	0	0	6,451	1,957	0	1,957	2,061	(105)
ch	97	6,856	2,144	0	0	0	9,000	2,730	0	2,730	3,436	(706)
	97	7,960	221	0	0	0	8,181	2,481	0	2,481	2,749	(267)
	97	7,160	196	0	0	0	7,356	2,231	0	2,231	2,061	169
e	97	8,002	2,077	0	0	0	10,079	3,057	0	3,057	2,749	308
	97	8,765	243	0	0	0	9,008	2,732	0	2,732	2,749	(16)
	97	7,803	160	0	0	0	7,963	2,415	0	2,415	2,749	(334)
t.	97	7,505	3,060	0	0	0	10,565	3,204	0	3,204	3,436	(232)
	97	7,958	290	0	0	0	8,248	2,501	0	2,501	2,061	440
	97	7,871	162	0	0	0	8,033	2,436	0	2,436	3,436	(999)
	97	8,561	2,961	0	0	0	11,522	3,495	0	3,495	2,061	1,433
al	**97**	90,056	11,514	0	0	0	101,570	30,805	0	30,805	29,548	1,257
	98	3,900	361	313	0	(114)	4,460	1,353	(5)	1,348	2,749	(1,400)
	98	734	135	247	0	(195)	921	279	(84)	196	687	(492)
ch	98	0	0	610	0	(4,504)	(3,894)	(1,181)	(367)	(1,548)	0	(1,548)
l	98	0	0	4,543	0	(4,683)	(140)	(42)	(277)	(319)	(204)	(115)	
	98	0	0	4,709	3,724	(2,863)	5,570	1,689	(275)	1,415	(204)	1,619
e	98	0	0	627	0	(1,530)	(903)	(274)	(116)	(390)	(204)	(186)
	98	0	0	440	0	(711)	(271)	(82)	(31)	(113)	(204)	91
	98	0	0	1,146	0	(299)	847	257	(34)	223	(204)	427
t.	98	0	0	435	0	(282)	153	46	(16)	31	(204)	235
	98	0	0	330	0	(175)	155	47	(7)	40	0	40
	98	0	0	283	0	(177)	106	32	(9)	23	0	23
	98	0	0	304	0	(126)	178	54	(6)	48	0	48
al	**98**	4,635	496	13,987	3,724	(15,659)	7,183	2,179	(1,225)	953	2,210	(1,257)
AND	**TOTAL**	94,691	12,010	13,987	3,724	(15,659)	108,753	32,983	(1,225)	31,758	31,758	0

Government of Canada 3-month T-Bill Rate 3.21%

Net Present Value of Surplus/Deficit (Beginning of 1997) 22.3

APPENDIX TABLE 4

TOTAL FEDERAL AND PROVINCIAL TAX COLLECTED BY SOURCE FOR THE 1995, 1996, AND 1997 TAXATION YEARS

($ millions)

Source	1995	1996	1997
1. Deductions at Source	86,397	90,278	94,691
2. Instalment Payments (collections)	9,610	10,862	12,010
3. Payment on Filing and Arrears	11,964	13,504	13,987
4. Accounts Receivable	1,947	883	3,724
5. Refunds due to Overpayment of Tax	(13,904)	(14,643)	(15,659)
6. Net Collections	96,014	100,884	108,753
Note:			
Refundable Provincial Credits	1,356	1,249	1,225

Source: Revenue Canada

APPENDIX TABLE 5

DETERMINATION OF FEDERAL TAX ASSESSED

($ millions)

	1995	1996	1997
BFT (Assessed as of Dec. 31)	65,179.9	68,611.5	74,989.1
Federal Surtax	2,449.8	2,653.0	2,961.5
Federal Tax Reductions	(597.5)	(458.8)	(478.2)
Special Quebec Abatement	(2,299.3)	(2,396.0)	(2,537.1)
Supplementary Taxes of Prior Years	0.0	0.0	0.0
Unapplied Adjusted(1) for Quebec Abatement	688.1	633.2	834.3
Total Federal Tax Assessed	65,421.1	69,042.9	75,769.6

(1) Total unapplied less provincial share less Quebec abatement applicable to Federal share of unapplied.

DETERMINATION OF PROVINCIAL TAX ASSESSED

($ millions)

	1995	1996	1997
Gross Provincial Tax (Assessed as of Dec. 31)	28,317.2	29,249.8	29,509.7
Provincial Tax Reduction	(462.3)	(452.8)	(494.5)
Foreign Tax Credit	(62.8)	(70.6)	(79.9)
Surtax and Flat Taxes	2,470.9	2,815.0	3,675.1
Unapplied (provincial share)	330.1	300.2	373.2
Total Provincial Tax Assessed	30,593.1	31,841.6	32,983.5

DETERMINATION OF PROVINCIAL SHARE OF TOTAL TAX ASSESSED

($ millions)

	1995	1996	1997
Federal Tax Assessed	65,421.1	69,042.9	75,769.6
Provincial Tax Assessed	30,593.1	31,841.6	32,983.5
Total Tax Assessed	96,014.2	100,884.5	108,753.1
Provincial Share (%)	31.86%	31.56%	30.33%

Source: Department of Finance, *Final Determination of Payments under the Tax Collection Agreements*